

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

77-6010

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 77-6010, 6011, 6019

BRITISH AMERICAN COMMODITY OPTIONS CORP., et al.,

Plaintiffs-Appellants-Cross Appellees,

v.

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES
TRADING COMMISSION, et al.,

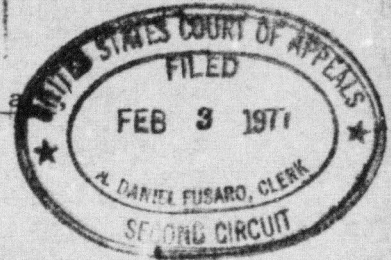
Defendants-Appellees-Cross Appellants.

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, et al.

v.

THE COMMODITY FUTURES TRADING COMMISSION, et al.,

Defendants-Appellees-Cross Appellants.



On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF THE COMMODITY FUTURES TRADING COMMISSION
AND ITS MEMBERS, APPELLEES-CROSS APPELLANTS

RICHARD E. NATHAN
Acting General Counsel

FREDERIC T. SPINDEL
Associate General Counsel

VIRGINIA F. CRISMAN
Attorney

Commodity Futures Trading
Commission
2033 "K" Street, N.W.
Washington, D.C. 20581

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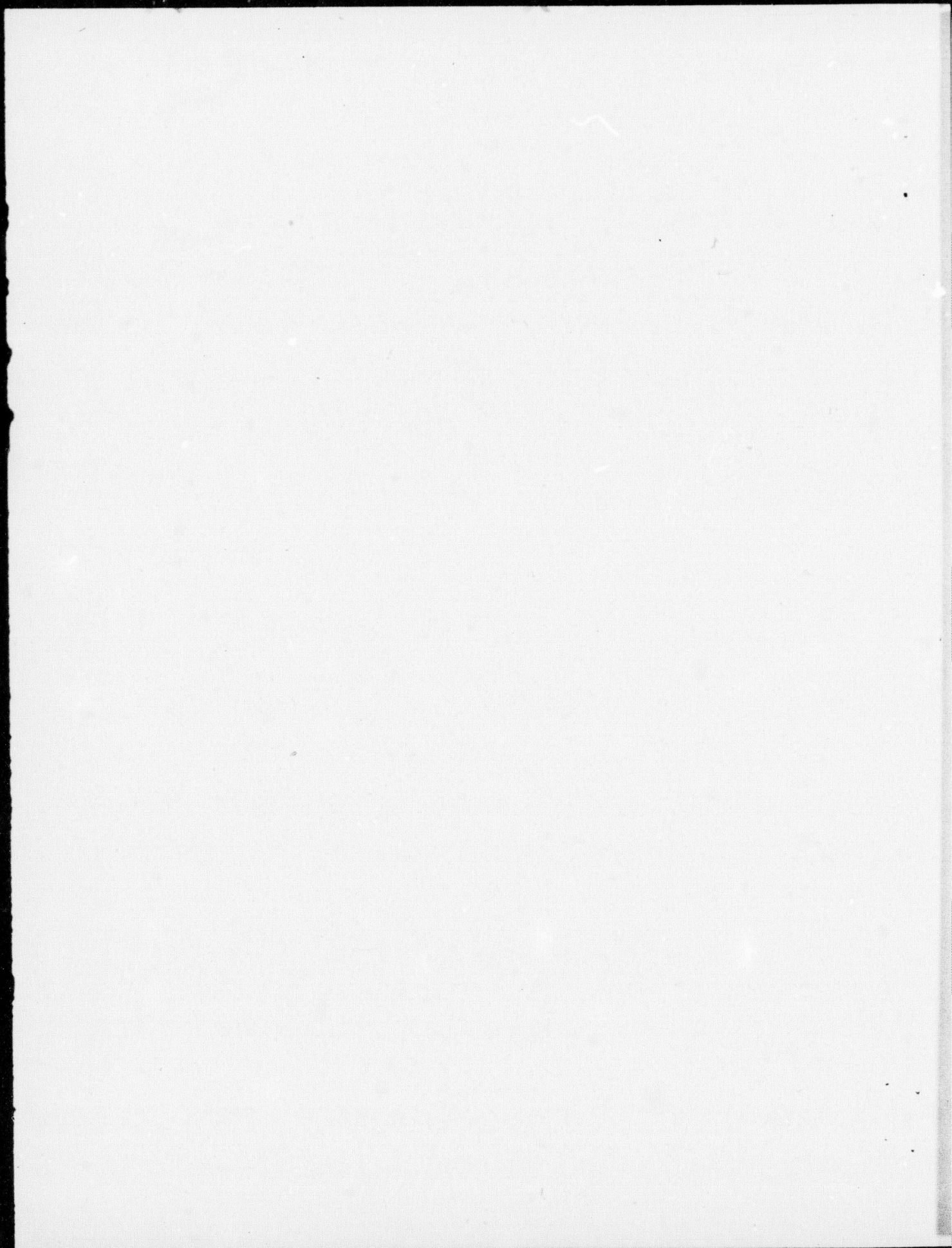
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(November 24, 1976)



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THE COMMODITY FUTURES TRADING COMMISSION, et al.,
Defendants-Appellees-Cross Appellants.

On Appeal from the United States District Court
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BRIEF OF THE COMMODITY FUTURES TRADING COMMISSION
AND ITS MEMBERS, APPELLEES-CROSS APPELLANTS

COUNTERSTATEMENT OF THE
ISSUES PRESENTED

In an action seeking pre-enforcement judicial review of
the commodity option rules adopted by the Commodity Futures

Trading Commission (41 Fed. Reg. 51808, November 24, 1976):

1. Did the District Court have a basis in fact or in law to enjoin enforcement of the segregation provisions of Section 32.6 of the commodity option regulations;
2. Did the District Court correctly uphold on summary judgment the validity of all other provisions contained in the Commission's commodity option regulations; and
3. Did the District Court correctly hold that the Commission's other regulations were not arbitrary and capricious.

PRELIMINARY STATEMENT AND SUMMARY

These are appeals from an Order and Judgment entered on January 6, 1977, (JA526)^{1/} by the District Court for the Southern District of New York (per Knapp, J.) in consolidated actions instituted by plaintiffs to obtain pre-enforcement judicial review of commodity option regulations adopted by the Commodity Futures Trading Commission in 41 Fed. Reg. 51808, et seq. (November 24, 1976) (SA1).^{2/}

The challenged regulations were adopted by the Commission primarily under authority of Section 4c(b) of the Commodity Exchange Act, as amended, 7 U.S.C. §6c(b), and are the first stage of a two-step comprehensive regulatory scheme under which the Commission proposes to implement its Congressional mandate effectively to regulate option trading in the United States. They set forth the terms and conditions under which transactions in commodity options will be permitted by imposing registration, minimum financial, segregation, disclosure, recordkeeping and antifraud requirements upon persons who wish to engage in the business of buying commodity options for, or selling commodity options to, members of the public.

1/ "JA ____" refers to pages of the Joint Appendix. Parts of the record on appeal which are not contained in the Joint Appendix are cited by reference to the number and description of the document reflected on the clerk's certificate and the page thereof. Pages of the brief filed by appellants British American Commodity Options Corp. and Lloyd, Carr & Co. are cited as "B. Br. ____." Pages of the brief filed by appellants National Association of Commodity Option Dealers ("NASCOD"), et al., are cited as "N. Br. ____."

2/ Because appellants failed to reproduce in the Joint Appendix certain parts of the record which we specifically designated for inclusion, we have been required to prepare a Supplemental Appendix annexed to this brief. "SA ____" refers to pages of the Supplemental Appendix.

Plaintiffs, which are nine firms engaged in the business of offering to the public so-called "London commodity options"^{3/} and a trade association of which they are members,^{4/} broadly attack the validity of the Commission's regulations on the grounds that they are arbitrary and capricious and that the Commission has failed to comply^{5/} with due process and various procedural requirements (JAL-3, 783).^{6/} Plaintiffs seek declaratory and injunctive relief. On November 15, 1976, plaintiffs moved for an order preliminarily enjoining enforcement of the regulations, and on December 3, 1976, the Commission cross-moved

3/ A commodity option gives the purchaser, upon payment of the premium therefore, the right, during a specified period of time, to buy ("call") and/or sell ("put") at a set "striking" price a specific futures contract or, in the case of an option on an actual commodity, a specific quantity of that commodity. So-called "London options" of the type offered by plaintiffs relates to futures contracts on commodities traded on the London commodity markets. (JA501, 89-91, 790).

4/ NASCOD was formed by a small group of option firms in October 1976, apparently for the principal purpose of opposing the Commission's regulations.

5/ Although plaintiffs purport in their briefs to represent the views of other members of the "commodity options industry" (see, e.g., B. Br. 31, 36, 38, 39, 43, 44, 47, N. Br. 24) plaintiffs have sought relief only in their own behalf and not on behalf of a class. There is no basis in the record or otherwise for their claims that other commodity option firms share their views in any material particular.

6/ British American and Lloyd Carr filed their original complaint in the court below on November 15, 1976 (JAL). Following two unsuccessful attempts by these plaintiffs to obtain a temporary restraining order against enforcement of the regulations (JAL, 264), NASCOD and the nine plaintiff option firms (including British American and Lloyd Carr) on December 8, 1976, instituted a separate suit in the District Court for the District of Columbia and moved before that court for a temporary restraining order (JA777), which was denied. With NASCOD's consent, that action was then transferred to the Southern District of New York, and was consolidated by Judge Knapp with the action there pending (JA520, fn. 1).

for summary judgment upon the undisputed material facts reflected in the certified record of the rulemaking proceeding, which was filed with the court below. (JA350).

The Order and Judgment under review—which was based on a memorandum opinion issued by the district court on December 21, 1976 (JA500)—granted the Commission's motion for summary judgment as to all issues regarding the validity of the challenged regulations other than the provision contained in Section 32.6, which requires that a commodity option dealer segregate in a separate account for the benefit of its customers 90% of the funds received from each customer until such time as the option purchased for the customer has either expired or has been exercised and all obligations under the option have been fulfilled. (JA526). With respect to this segregation provision the district court preliminarily enjoined the Commission, during the pendency of the action, from enforcing that requirement against any plaintiff who is in the business of selling options as an agent of a principal (JA527).

In its memorandum opinion, the court below ruled that the Commission did not appear to have adequately justified the requirement of Section 32.6 that an option dealer segregate 90% of the funds received from its customers for the purchase of options, particularly in view of the adverse financial burden which the court believed the segregation requirement would impose upon option dealers who act as "agents for London principals" and who, like plaintiffs, are required to transfer to London a substantial portion of the purchase price received from

7/ The Commission and its five individual members have all been named as parties defendants. Unless the context otherwise requires, all defendants are collectively referred to as "the Commission".

their customers (JA514). On this basis, the court concluded (JA513) that plaintiffs had a reasonable likelihood of success in establishing that the Commission had acted arbitrarily and capriciously in imposing segregation requirements upon option dealers who act only as agents. The district court also determined (JA513) that plaintiffs were threatened with irreparable injury in that, being required to forward to London the premiums for options they sell to their customers (which the court assumed to represent at least 75% of the funds received from each customer), they could not long remain in business if required to segregate in the United States an amount equal to 90% of the funds the customer had provided.

The court held, however, (JA515-518) that in adopting the balance of the regulations, the Commission had complied with all applicable procedural requirements of the Commodity Exchange Act and the Administrative Procedure Act. It also rejected plaintiffs' contentions that these regulatory provisions were unreasonable, emphasizing that plaintiffs' principal claims were predicated on a misunderstanding of the effect of the regulatory requirements.

On January 10, 1977, the Commission moved for reconsideration asking that the district court vacate the preliminary injunction and either grant the Commission's motion for summary judgment as to the segregation requirement or, in the alternative, order the prompt holding of an evidentiary hearing to resolve disputed facts. In support of its motion the Commission showed, with specific reference to documents that had been submitted for the district court's consideration: that plaintiffs do not sell options as agents for principals in London or elsewhere,

but, instead, acquire options as agents for the accounts of their customers (JA588-560); that there were very substantial reasons--which Congress itself had recognized, and which were reinforced by the record in the Commission's rulemaking proceedings--why commodity option investors needed the kind of protection segregation will provide (JA561-564); and that, after considering various alternatives, the Commission had reasonably concluded that segregation was an appropriate means to assure the necessary protections (JA571-572). The Commission also demonstrated that there was virtually no evidence in the record upon which the district court could reasonably have concluded that plaintiffs will suffer any significant injury--much less judicially cognizable irreparable injury--if required to comply with the segregation provision (JA577-581).

While the district court denied the Commission's motion, it recognized that the Commission had made telling points in seeking reconsideration (see Transcript of Hearing, January 12, 1977, JA615), and the district court candidly admitted that it might have erred in certain seemingly important factual assumptions it had made (id. at JA618-619). The district court admitted that it should have taken testimony on the question of irreparable injury (JA618) and admitted that perhaps it did not understand the procedure in option transactions (JA619). Surprisingly, however, the district court asserted: "I have no function in this case to find facts." The Court added (id. at JA617):

"The function of a district court in my view in this kind of a case is to focus the issue and permit the parties to make a record, and then be as unobstructive as possible and get the parties to the Court of Appeals which is where they want to be."

On this basis, it declined to reconsider its decision. At the same time, the court denied plaintiffs' request for a "stay" pending appeal of the effectiveness of those regulations that the court had upheld (JA617, 620). Thereafter, on January 13, 1977, both the Commission and plaintiffs noticed their respective appeals from the district court's decision (JA627-30).

By orders dated January 18, 1977, this Court denied plaintiffs' motion for an injunction pending appeal with respect to the regulations the district court had held to be valid, and directed an expedited briefing and argument schedule.^{8/}

STATUTES AND RULES INVOLVED

Sections 4c(b), 8a(5) and 15 of the Commodity Exchange Act, as amended, 7 U.S.C. §§6c(b), 12a(5) and 19 (Supp. V, 1975), pertinent provisions of the Administrative Procedure Act, 5 U.S.C. §§553b, 553d and 706, and Sections 1.17 and 1.19 of the Commission's General Regulations, 17 C.F.R. 1.17 and 1.19 (1976) are set forth in the Statutory Appendix, infra, at SA48.

^{8/} Under the schedule established by this Court appellants were to file their briefs on January 26, the Commission to file its brief on February 3, and oral argument to be held on February 9, 1977. Notwithstanding this Court's order that cross-appeals be expedited pursuant to a drastically curtailed briefing schedule, plaintiffs' counsel served their briefs upon the Commission by ordinary mail. The omission of express language by the Court as to service, though plainly implied, has been taken as a license to deprive the Commission the same opportunity to prepare its brief as the plaintiffs have enjoyed. As a consequence, the brief of appellant British American was not received by the Commission until Friday, January 28, 1977, and the brief for the National Association of Commodity Option Dealers--which we were not informed would be separately submitted--was not received until 2:00 p.m. Monday, January 31, 1977. On February 2, 1977, we were advised by the office of the Clerk of this Court that we would be required to file our brief physically with the Court no later than 5:30 p.m. on February 3--a requirement which has been met.

The commodity option regulations adopted by the Commission in 41 Fed. Reg. 51808, et seq. (November 24, 1976) are set forth in the Supplemental Appendix, infra, at SA1.

COUNTERSTATEMENT OF THE CASE

1. The Statutory Scheme of Regulation under the
Commodity Exchange Act and the Congressional
Mandate Concerning Commodity Option Transactions

In response to the increasing public participation in the commodities markets and the proliferation of abuses in unregulated commodity transactions, Congress, on October 23, 1974, enacted the Commodity Futures Trading Commission Act of 1974, 88 Stat. 1389. That legislation extensively amended the Commodity Exchange Act, 7 U.S.C. §§1-17b (1970), and created the Commission as an independent federal regulatory agency, which, since April 21, 1975, has been responsible for administering and enforcing the provisions of the Commodity Exchange Act, as amended. Prior to the 1974 amendments, the Act had been administered by the Commodity Exchange Authority of the Department of Agriculture, and applied only to trading in certain specifically-enumerated agricultural commodities.^{9/} The 1974 amendments greatly expanded the coverage of the Act to encompass virtually all previously unregulated commodities, by

^{9/} Those commodities were wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrate orange juice. 7 U.S.C. §2 (1970).

bringing within its scope "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in" ^{10/}

Those amendments also greatly expanded the regulatory authority of the Commission as compared to its predecessor and gave the Commission "exclusive jurisdiction" to regulate:

"accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option' . . .), and transactions involving contracts of sale of a commodity for future delivery" ^{11/}

The main area of Commission responsibility relates to contracts of sale of commodities for future delivery traded or executed on boards of trade, (i.e., commodity exchanges) that have been designated by the Commission as "contract markets" for specific commodity futures contracts. ^{12/} It is unlawful to effect a commodity futures transaction otherwise than by or through a member of a board of trade that has been designated as a contract market by the Commission. ^{13/} In order for a board of trade to obtain designation as a contract market for a particular commodity futures contract, it must meet rigid requirements

^{10/} Section 2(a)(1) of the Act, 7 U.S.C. §2 (Supp. V, 1975).

^{11/} Section 2(a)(1) of the Act, 7 U.S.C. §2 (Supp. V, 1975) (emphasis added).

^{12/} A "board of trade" is defined in Section 2(a)(1) of the Commodity Exchange Act, 7 U.S.C. §2 (Supp. V, 1975), as

" . . . any exchange or association, whether incorporated or unincorporated, of persons who shall be engaged in the business of buying or selling any commodity or receiving the same for sale on consignment"

^{13/} Section 4 of the Act, 7 U.S.C. §6 (Supp. V, 1975).

and must continue, after designation, to maintain specific standards, including enforcement of its rules, preventing manipulation and cornering of the market and maintaining a clearing system to secure the financial integrity of futures contracts by guaranteeing performance of trades made in such contracts.^{14/} In addition, futures commission merchants^{15/} and other professional participants in the markets must register with the Commission and comply with antifraud, reporting and record-keeping provisions.^{16/} Futures commission merchants are also subject to minimum capital requirements^{17/} and, under an express provision of the Act, must segregate customer funds.^{18/}

In contrast to the long-established system of regulation over the organized commodity futures exchanges and the panoply of financial and other protections available to members of the public who trade on designated contract markets, the selling of commodity options to the

^{14/} See Sections 5 and 5a, 7 U.S.C. §§7, 7a (Supp. V, 1975).

^{15/} A "futures commission merchant" is defined in Section 2(a)(1) of the Act, 7 U.S.C. §2 (Supp. V, 1975), as an individual or entity

" . . . engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom"

^{16/} See, e.g., Sections 4b, 4d, 4e, 4f, 4g, 4i, 4k, 4m and 4n, of the Act, 7 U.S.C. §§6b, 6d, 6e, 6f, 6g, 6i, 6k, 6m, 6n (Supp. V, 1975).

^{17/} See Regulation 1.17, 17 C.F.R. §1.17 (1976).

^{18/} Section 4d of the Act, 7 U.S.C. §6d (Supp. V, 1975).

public, as it has developed in this country over the past 15 years, has not previously been subject to comprehensive regulation by any governmental agency. The Commodity Exchange Authority, the predecessor to the Commission, did not have jurisdiction over options on any commodities other than those specifically enumerated in Section 2(a)(1) of the Commodity Exchange Act (n. 9, supra); as to those enumerated commodities, option trading was prohibited and continues to be prohibited. See Section 4c(a) of the Act, 7 U.S.C. §6c(a) (Supp. V, 1975).

Prior to the enactment in 1974 of the commodity option provisions that are now contained in Section 4c(b) of the Act, 7 U.S.C. §6c(b), neither the Commodity Exchange Authority nor any other governmental agency had the power effectively to regulate options on other commodities.^{19/} To fill this "regulatory gap," the 1974 amendments to the Act reflected a Congressional effort, among other things, fully

" . . . to regulate trading . . . in options relating to commodities or commodity futures, because such trading is now poorly regulated, if it is regulated at all" ^{20/}

The Congressional intent that commodity option trading be regulated completely and effectively arose out of scandals that had occurred in the late 1960's and early 1970's, which involved the financial failure of firms that sold options for which no underlying futures contract had been purchased. The House Committee on Agriculture reported that commodity option customers had been defrauded of millions of dollars after

^{19/} See Section 4c(a)(B) of the Act, 7 U.S.C. §6c(a)(B) (1970) and (Supp. V, 1975).

^{20/} 120 Cong. Rec. H10247 (daily ed., Oct. 9, 1974).

having been told that they were purchasing the "right" to buy or sell commodity futures contracts--a right for which they had paid a premium. The premiums had not been large and, since there were no margin calls, the option firms had attracted many customers. Because it was relatively more expensive to purchase a commodity futures contract, many option firms had written options without "covering" their obligation by the acquisition of an offsetting position in the futures market. The House Committee noted:

"It has been documented that, in some of these firms, customers who desired the proceeds of their transaction in these options were actually paid in many instances from other customer's accounts, and eventually the pyramid structure created, where one customer's account is robbed to pay another, collapses" 21/

Several persons testified before the Senate Committee on Agriculture and Forestry that, except for regulatory provisions relating to securities, no provision of federal or state law appeared to have had even arguable application to option activities. In an attempt to deal with increasing fraudulent activity involving commodity options for which no other remedy appeared, securities laws provisions had been invoked. But state blue sky laws and the federal securities laws had not

21/ H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 38, 37 (1974); See also Hearings on H.R. 11955 before the House Committee on Agriculture, 93d Cong., 2d Sess., ser. 93-TT, at 181-182, 194-196 (1974); Hearings on S. 2485, S. 2578, S. 2837 and H.R. 13113 before the Senate Committee on Agriculture and Forestry, 93d Cong., 2d Sess. pt. 1, at 224-225, pt. 3, at 682-683, 830-835 (1974) (testimony of Tom Maher and Glenn Willet Clark, and statement prepared by James Ryan and Richard Malm).

been designed to deal with commodity options,^{22/} and had proved generally ineffective for the purpose.^{23/} For this reason it was suggested that the new Commission be given broad and exclusive authority to regulate commodity option transactions.^{24/}

In response to testimony in hearings on the 1974 amendments that commodity option transactions may serve an economic purpose,^{25/} Congress vested the Commission with pervasive authority over options relating to all commodities which would newly become subject to the Act by reason of the 1974 amendments, mandating that the Commission determine whether option transactions would be permitted and, if so, under what circumstances. This statutory authority is set forth in Section 4c(b) of the Act, 7 U.S.C. §6c(b) (Supp. V, 1975), which provides in pertinent part:

"No person shall offer to enter into, enter into, or confirm the execution of, any [commodity option] transaction . . . contrary to any rule, regulation,

^{22/} See, e.g., Hearings on S. 2485, S. 2578, S. 2837 and H.R. 13113 before the Senate Committee on Agriculture and Forestry, 93d Cong., 2d Sess., pt. 1, at 224-225 (1974) (testimony of Tom Maher).

^{23/} Id., pt. 3, at 682-683 (testimony of Glenn Willet Clark) and 830-835 (Statement prepared by James Ryan and Richard Malm). See generally Glazer v. National Commodity Research and Statistical Service, Inc., et al., 7th Cir., No. 74-1861 (January 7, 1977), in which it was recently held that commodity options are not securities as defined in the federal security laws.

^{24/} See generally Hearings on H.R. 11955 before the House Committee on Agriculture, 93d Cong., 2d Sess., ser. 93-TT, at 194-196, 329 (1974).

^{25/} See Hearings on H.R. 11955 before the House Committee on Agriculture, 93d Cong., 2d Sess., ser. 93-TT, at 37, 40-41, 133, 176-180, 199, 251, and 329 (1974).

or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe"

This provision is implemented through the Commission's general rulemaking authority contained in Section 8a(5) of the Act, 7 U.S.C. §12a(5) (Supp. V, 1975), which broadly empowers the Commission

"to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of [the Act]"

Under these sections the Commission could have prohibited all commodity option trading, permitted all forms of commodity option trading subject to appropriate requirements or, as it has done here, allowed some forms of trading under certain terms and conditions and prohibited others.

2. The Record of Commission Rulemaking Relating to Commodity Option Transactions

The commodity option regulations adopted by the Commission on November 22, 1976, 41 Fed. Reg. 51808, 51814-51817 (November 24, 1976) (SA7-10) were promulgated after 19 months of extensive Commission study of the complex economic and other factors related to the offer and sale of commodity options in the United States. The process consumed substantial Commission resources, involved broad public participation, and consisted of a continual assessment by the Commission of various alternative regulatory approaches for dealing with options.

a. Adoption of Commodity Option Antifraud Rule

On April 25, 1975, just four days after the Commission came into existence, the Commission proposed an antifraud rule relating to commodity options and solicited written public comments on the proposal. 40 Fed. Reg. 18187 (April 25, 1975) (JA709). After considering all

the comments received, the Commission, on June 24, 1975, adopted an antifraud rule broadly proscribing fraudulent and deceptive practices and the making of false statements in connection with commodity option transactions. 17 C.F.R. §30.01 (1976), 40 Fed. Reg. 26504 (June 24, 1975) (JA711). In the release announcing the adoption of this antifraud rule, the Commission emphasized that, since the Commission had been granted exclusive jurisdiction with respect to option transactions, there existed a regulatory gap which was necessary to close as quickly as possible.^{26/}

b. The Commission's October 22, 1975, Release Inviting Public Comment on Proposed Alternatives for Regulating or Prohibiting Commodity Options

On October 22, 1975, the Commission announced that it was considering the adoption of rules to regulate--or perhaps forbid--transactions in commodity options, and that it had assigned to its Advisory Committee on the Definition and Regulation of Market Instruments ("the Advisory Committee") the responsibility to study and make appropriate recommendations to the Commission on the subject of commodity options. 40 Fed. Reg. 49360 (October 22, 1975) (JA714). In its October 22 release, the Commission expressed the view that because of the proliferation of commodity option offerings, which appeared in most cases not to be attended by adequate assurances that the issuers of options would be able to perform their obligations, a need existed to expand regulatory protections for option customers beyond those then afforded by its

^{26/} For this reason, the Commission stated it would be contrary to the public interest to delay effectiveness of the antifraud rule for the 30 days normally required under the Administrative Procedure Act, 5 U.S.C. 553d. 40 Fed. Reg. 26504, 26506 (June 24, 1975) (JA713).

antifraud rule 40 Fed. Reg. 49360 (JA714).^{27/} Accordingly, while the Commission stated it would be inappropriate for it to make any definitive judgment concerning commodity options without thorough study, the Commission requested public comments concerning what, if any, temporary rules might be promulgated. For this purpose, comments were solicited both as to option trading in general and on the merits of several specific regulatory alternatives.

Although the district court appears to have assumed (JA512-513) that the regulatory scheme of the challenged regulations was not proposed until October 1976 and had been hastily adopted in November 1976 without meaningful public comment,^{28/} one of the alternatives expressly suggested by the Commission in its October 1975 release was "forbidding commodity option transactions by any person not registered with the Commission as a futures commission merchant"--the very approach embodied in the option regulations ultimately adopted in November 1976, which are at issue in the instant case. 40 Fed. Reg. at 49360-49361 (JA714-15).^{29/} Moreover, in

^{27/} Plaintiffs, in contending that the Commission's option regulations are unjustified, would have this Court accept their judgment in lieu of the Commission's that the Commission's antifraud rule and certain other requirements provide sufficient customer protection (B. Br. 2).

^{28/} The plaintiffs assert as much in their brief (B. Br. 20).

^{29/} Other alternatives proposed were:

1. prohibiting all commodity option transactions;
2. restricting commodity option transactions to contract markets;
3. forbidding option transactions except in accordance with a business plan that has been approved

discussing the possibility of requiring registration of option dealers as futures commission merchants--thereby limiting options trading to persons who meet basic fiduciary and other standards established by Congress--the Commission contrary to the finding of the district court (JA13) specifically raised the possibility of a segregation requirement emphasizing that to implement that scheme "extensive study would be required to determine whether to adopt or amend Commission rules concerning segregation of customer funds, hedging of options and other customer protection standards" to supplement the statutory pattern of regulation, which had been designed to protect futures customers, in order to meet the unique regulatory problems that would be presented by commodity option activities. 40 Fed. Reg. 49361 (October 22, 1975) (emphasis added) (JA715). The Commission also requested commentators to address particular economic considerations relating to commodity options^{30/} and, pertinent to issues of meaningful opportunity for public

^{29/} (footnote continued)

by the Commission;

4. prohibiting "naked" options. . . ."

The Commission explicitly invited public comment on the effects of a temporary or permanent prohibition of commodity option transactions. The Commission particularly inquired whether there were legitimate enterprises offering commodity options which would suffer substantial adverse effects from the ban or whether they could, without serious detriment, easily divert resources devoted to option transactions to other profitable opportunities. Id. (JA714-15).

^{30/} Among other things, the Commission urged comment on

- "1. What useful economic functions are performed by commodity option trading? In what ways

(footnote continued)

comment, and the reasonableness of imposing requirements to protect option customers against insolvency raised in the case at bar, asked members of the public to respond specifically to the following questions, among others:

- "3. If option trading should be permitted, what form of regulation would be most appropriate and what specific rules should be adopted to protect against fraudulent acts and practices and to provide financial safeguards to the customers of persons who are offering and selling options?

.

6. What consideration should be weighed in determining whether option trading should be restricted to contract markets? If it is believed that option trading should be permitted otherwise than through the facilities of contract markets, what form of regulation would be appropriate?
7. What additional considerations, if any, would be relevant to whether or in what manner trading should be permitted in foreign commodity options, including the so-called 'London' option?"

40 Fed. Reg. at 49361-49362 (emphasis added) (JA715-716).

30/ (footnote continued)

do existing offerings of commodity options perform these economic functions.

2. Could option trading have an adverse economic effect upon futures trading in terms of liquidity or otherwise? If so, do these economic effects differ with respect to agricultural as contrasted with non-agricultural commodities?"

Id. at 49361. (JA715).

c. The February 20, 1976, Rule Proposals

After consideration of the various comment letters received on the regulatory issues it had posed,^{31/} on February 20, 1977, the Commission published proposed temporary rules to govern commodity option transactions. 41 Fed. Reg. 7774 (February 20, 1976) (JA55).^{32/} The proposals contained registration, recordkeeping and minimum

^{31/} Although plaintiff British American commenced business operation in October 1975 (see CFTC v. British American Commodity Options Corp., CCH Comm. Fut. L. Rep. ¶20,224 n. 12 (October 20, 1976), it tendered no written submission in response to the Commission's October 22, 1975, release.

^{32/} In announcing its proposal, the Commission stated that it

"... expects to receive recommendations [on option trading] from its Advisory Committee . . . by no later than March 30, 1976. After the Commission has had an opportunity initially to evaluate those recommendations and the oral and written comments it receives on the proposed rules, the Commission will determine whether it will require additional time to study the recommendations and comments in order to evaluate the extent to which they should be included as part of a permanent regulatory program. If the Commission believes that such additional time is required, the proposed rules may be adopted as interim and temporary rules only. Commentators should also be aware that although the proposed regulations relate to transactions which are not entered into on a contract market, the Commission is affirmatively considering permitting commodity option transactions to be traded on or subject to the rules of a contract market which have been approved by the Commission as adequate to effectuate the purposes of the Act. The Commission would particularly welcome comments on what standards (differing from or similar to those proposed) should be applied if such transactions are traded under the protections of a clearing association of a contract market. . . . Ultimately, the Commission may adopt regulations which restrict commodity option transactions to trading on contract markets."

financial requirements as well as a provision designed to effect disclosure of pertinent information to option customers--regulatory concepts which have also been utilized in the option regulations ultimately adopted.^{33/} Because the February 20 proposals embodied a substantially different approach to the regulation of commodity option transactions than the approach ultimately adopted by the Commission it was not found necessary to include provisions for the segregation of customer funds or the delivery of a disclosure statement to prospective option purchasers.

Thus, in contrast to the option regulations adopted in November 1976, which preclude persons who solicit or accept funds in connection with an option transaction also to issue or assume financial responsibility for fulfillment of the option, the February proposals would have permitted option dealers to both write and sell options.^{34/} Moreover, unlike the provisions finally adopted, an option dealer, in order to meet

^{33/} Among other things, the February rule proposals would have made it unlawful for any commodity option dealer to offer or sell any commodity option unless the dealer (1) had total assets in excess of total liabilities and maintained a net-working capital in excess of \$100,000; and (2) was registered as a commodity option dealer with the Commission. The proposals also would have required an option dealer, in connection with offers to enter into commodity option transactions, to inform each prospective purchaser that the dealer had filed an application in connection with its registration with the Commission containing detailed information about the dealer, the dealer's business operations, its financial condition, the options offered and the charges incurred, and that copies of such filings were available for public inspection at all offices of the dealer and at the Commission's offices in Washington, D.C. See proposed §§32.2, 32.4, 32.5, 32.9, 32.10, at 41 Fed. Reg. 7775, 7780-84 (JA61-65).

^{34/} See proposed Sections 32.2, 32.5, 41 Fed. Reg. 7780-81 (February 20, 1976) (JA61, 62). The proposed rules did not require firms to register as futures commission merchants; futures commission merchants would have been permitted to write options by virtue of the repeal of §1.19, which was also being proposed at that time. 41 Fed. Reg. 7780 (JA61).

the \$100,000 minimum net capital requirement proposed in February, would have been allowed to include as a current asset in its computation only those of its assets maintained in the United States (thereby excluding premiums paid to London) and would have been required to mark open option positions to the market on a daily basis and to include in its computation, as a current liability unrealized gains due to customers on open positions in its computation. Consequently, under the rules proposed in February 1976, all option dealers would have been required to have had sufficient assets in the United States not only to cover the initial investment of customers--substantially as required under the segregation provisions of Section 32.6, adopted in November 1976--but also to fulfill the contractual obligations of the commodity options themselves.

In view of the stringent minimum net capital requirement set forth in the February proposals, segregation was not included in the proposed regulations. Nevertheless, the Commission specifically requested public comment concerning whether some form of segregation should be imposed and whether option dealers should be required to provide prospective customers with a written disclosure statement:

"With respect to segregation of premiums, while the Commission has determined not to impose such a requirement on commodity option dealers . . . , it is particularly interested in receiving comments as to whether such a requirement should and could be imposed. With respect to delivery in advance of disclosure statements to prospective purchasers, . . . the Commission is also interested in the views of interested persons as to whether such a requirement should be imposed." 35/

35/ 41 Fed. Reg. at 7776 (JA57).

In addition to the period for written public comment with respect to the February 1976 proposed rules--which extended through March 31, 1976--the Commission, although not required to do so, held an oral hearing on March 8 and 9, 1976, to permit further presentation on relevant issues and to obtain the broadest possible public participation in the rulemaking process. (JA65) At the oral hearing on March 8, various witnesses, including counsel for plaintiff British American, appeared and presented their views on the proposed regulations (JA724-776). Written comments were also received, a number of which urged, contrary to the Commission's proposal at that time, that a segregation requirement be imposed to protect customers (JA719, 722).

d. The Advisory Committee Report

On July 6, 1976, the Advisory Committee transmitted its report on commodity option trading to the Commission. The report identified three broad categories of option trading that might occur in the United States: (1) trading in options through the facilities of contract markets designated by the Commission;^{36/} (2) trading in "domestic dealer options," i.e., domestic options issued and offered otherwise than through the facilities of a designated contract market; and (3) trading in "foreign options,"^{37/} whether or not originating on an organized foreign commodity exchange.

^{36/} At present, no commodity option trading takes place on designated contract markets.

^{37/} Foreign options currently traded in the United States include those sold on or through a member of one of the London commodity markets and cleared through the International Commodity Clearing House in London, and those issued by or through an individual member of the London Metals Exchange. Advisory Committee Report at p. x (JA89).

The Advisory Committee also determined that each of these categories might be subdivided into trading in "assignable" and "non-assignable" options,^{38/} into trading in "transferable" and "non-transferable" options,^{39/} and into options on futures contracts and options on the actual commodities themselves.

After over seven months of analysis, the Advisory Committee generally recommended that no form of option trading should be prohibited, provided that a satisfactory showing could be made with respect to each option category that certain basic customer protections available to participants in the futures markets, or their equivalents, could be provided to option customers. These essential protections concerned (1) segregation of funds; (2) a mechanism guaranteeing performance of the transaction; and (3) adequate supervision and control of trading practices and activities.^{40/}

The Advisory Committee found that contract markets provided these protections and, for that reason, that there would be no reason to prohibit options transactions effectuated through contract market facilities. Accordingly, the Advisory Committee recommended that option trading on contract markets should be allowed and should be regulated in a fashion similar to futures trading on contract markets.^{41/}

^{38/} An "assignable" option is an option capable of being conveyed to a third party in a secondary market. A "non-assignable" option may not be so conveyed. Advisory Committee Report at p. ix (JA88).

^{39/} A "transferable" option is capable of being liquidated by an equal and offsetting transaction. A "non-transferable" option may not be offset and can be liquidated only through exercise or lapse. Id. (JA88).

^{40/} Id. at 16. (JA125).

^{41/} Id. at 29. (JA138).

The Advisory Committee further recommended that persons wishing to offer domestic dealer options and foreign options should establish a system by which those options could be offered in the United States under circumstances providing safeguards substantively equivalent to those afforded futures customers on designated contract markets.

(JA138-144) If any such system were submitted to, and approved by, the Commission, the Advisory Committee also recommended that the Commission should require option dealers (1) to register with the Commission, (2) to maintain minimum working capital and net worth, (3) to "mark to the market" daily customers' open options positions, (4) physically to segregate customer moneys and property and unrealized net equity in customer accounts, and (5) to furnish a basic disclosure statement to prospective purchasers, containing, among other things, a description of mark-ups, charges and commissions and pertinent information concerning the particular option involved (JA152-164).

The recommendations of the Advisory Committee concerning segregation, financial responsibility and disclosure, are substantially reflected in the Commission's options regulations. (Compare JA156, 153, 159) with SA8, 7, 8, respectively). In formulating these recommendations the Advisory Committee (JA86) (as well as the Commission itself) (SA2) solicited and received numerous written comments from the public and, during the course of its deliberations, held a number of broadly-publicized open hearings in major cities in the United States to obtain the views of all interested persons (JA435, 582, 719, 722, 724).

In addition, the Advisory Committee specifically addressed the circumstances involved in the trading of London commodity options, holding various meetings with representatives of the London commodity exchanges and their members to ascertain the manner in which they operated and the protections, if any, afforded to option customers in the United States (JA150-151). Based upon these discussions the Advisory Committee reported to the Commission that:

"At the present time, neither United States nor London vendors of . . . [options cleared by the International Commodity Clearing House or vended through members of the London Metals Exchange] are required to segregate funds received from United States customers. Moreover, neither the ICCH nor the LME currently guarantees to United States customers the performance of obligations on any ICCH or LME option. The Advisory Committee has been informed that these and other circumstances, such as the absence of financial requirements for option dealers in the United States and the lack of regulation of the United States market for Foreign Options, make it very difficult for United States customers to obtain redress in the United States from dealers of 'London' options in the event of a default on the option transaction. On this basis, the Advisory Committee has determined that, to the extent possible, these deficiencies should be remedied by the Commission."

Advisory Committee Report at pp. 41-42 (emphasis added) (JA150-151).^{42/}

The absence of any meaningful protection for customers purchasing of London Options, was confirmed by comment letters submitted directly to the Commission by the London Commodity Exchange. The letters make clear that existing guarantees of performance run only to clearing members of the London exchanges, in whose names the option contracts are registered, and that the guarantee could not be extended to customers of an option

^{42/} The Commission specifically referred to this statement when announcing the adoption of the option rules. 41 Fed. Reg. 51812 (November 24, 1976) (SA5).

dealer in the United States unless and until exchange rules are amended to permit dealers who become clearing members of the London exchange to establish special segregated depository accounts for United States customers (JA435, 582). The London Commodity Exchange comment letters further explained that at present option premiums transmitted to London from option dealers in the United States are segregated--but not for the customer's benefit. Rather, they are placed in a "special grantor's premium account" to be paid to the London option writer's inability to perform, to be drawn upon by the ICCH for use in guaranteeing performance to the clearing member. There is no contingency upon which those funds would or could be returned to the customer in the United States (see JA 151).^{43/}

e. The October 8, 1976 Proposed Interim Regulations

After consideration of the public comments received on its prior proposals, the presentations made at its oral hearing on March 8, 1976, and the report and recommendations of its Advisory Committee, the Commission directed its staff on September 13, 1976, to prepare interim option regulations, and those proposed rules were published in the Federal Register on October 8, 1976. 41 Fed. Reg. 44560, 44566-68 (October 8, 1976) (SA17,17a,17b). These proposed interim regulations were announced by the Commission as the first stage of a two-step procedure to adopt comprehensive regulations for a limited, rigidly-controlled, three-year pilot program that may ultimately restrict commodity option transactions to domestic boards of trade and foreign

^{43/} At the Commission's March 8, 1976, oral hearing, plaintiffs' counsel conceded that the London guarantees do not run to option customers in the United States (JA745-46). See supra, p. 23.

commodities exchange systems that satisfy stringent regulatory requirements. 41 Fed. Reg. 44560 (October 8, 1976) (SAll). Through that test program, the Commission expects to obtain sufficient data involving the impact of commodity options trading on underlying futures and cash markets, the economic utility of such options trading, and the capabilities of exchanges to conduct adequate market surveillance and assure orderly markets in options, upon which to base a permanent regulatory program for commodity option transactions or, if necessary, to determine to ban options trading altogether. Id. (SAll).

The Commission stated that the interim regulations were designed to provide minimal customer protections in the offer and sale of commodity options, which until the second stage of the regulations could be implemented, would be allowed to continue to be conducted otherwise than through the facilities of designated exchange systems. The Commission explained that the registration, financial, segregation, and disclosure requirements contained in the proposals had been designed to effectuate the customer protection objective and to permit a gradual phase-in of the test program restricting option trading to designated domestic contract markets and Commission-recognized foreign commodities exchange systems.

At the time they were originally published, the Commission expressed its intention to adopt and make effective the proposed interim regulations on November 22, 1976. 41 Fed. Reg. at 44560 (SAll). Nevertheless, the Commission specifically provided a thirty-day period, until November 8, 1976, during which interested persons were invited to submit written comments to the Commission on the proposed rules. Id. at

44568 (JA17b). The Commission had contemplated in a proposed agenda made available to the public (JA491) that following adoption of the interim regulations in November, the second stage of the regulations would be proposed under a schedule permitting an oral hearing on that additional proposal to be held in December (JA or SA ^{44/}_____).

F. The Adoption of Interim Commodity Option Regulations on November 22, 1976

On November 22, 1976, the Commission adopted the option regulations substantially in the form it had proposed in October 1976. 41 Fed. Reg. 51808, (November 24, 1976), (SA1), after making certain technical and substantive revisions that the Commission deemed necessary in light of the comments it had received.^{45/} See 41 Fed. Reg. at 51801-51814 (SA3-7). Noting that Sections 4c(b) and 8a(5) of the Act, provided the Commission with broad statutory authority to promulgate these regulations, the Commission emphasized that its principal concern with respect to the regulation of commodity option transactions was to provide essential protections to commodity option customers. Id. at 51809 (SA2).

As announced in October 1976 and as adopted in November, the regulations generally (1) made it unlawful on and after January 17, 1977, for any person to accept money or property from an option customer as payment of the purchase price of a commodity option unless such person is

^{44/} There is no basis in fact for petitioners' claim (B. Br. 51) that the Commission ever indicated that a further oral hearing would be held on the first-stage proposals before they would be adopted.

^{45/} Plaintiffs incorrectly state (B. Br. 51) that the regulations as proposed on October 8 were "withdrawn", and other regulations then issued.

registered with the Commission as a futures commission merchant (§32.3, id. at 51814 (SA7)); (2) required individuals soliciting or accepting orders for commodity option transactions or supervising any person so engaged to register with the Commission as an associated person of a specified futures commission merchant by January 17, 1977 (§32.3, id. at 51814 (SA7)); (3) provided that registered futures commission merchants engaged in commodity option transactions maintain a minimum adjusted working capital the greater of \$50,000 or an amount computed in accordance with a specified formula (§1.17, id. (SA7)); and (4) required persons engaged in the business of offering commodity options to segregate in a separate account in the United States the money or property accepted from an option customer as payment of the purchase price of a commodity option, except to the extent of 10 percent of the purchase price, until expiration of the term of the option or, if the option is exercised, until all rights of the option customer under the option have been fulfilled (§32.6, id. at 51815-51816 (SA8,9)).

The regulations also require that option firms provide prospective option customers in advance of entering into an option transaction with a summary disclosure statement setting forth general information relating to the option being offered, including a listing of the elements comprising the purchase price to be charged and a general description of all other costs incurred. In addition, as part of the written confirmation of the execution of a transaction, a firm must also furnish the option customer with particularized price information regarding the option within 24 hours after execution. (§32.5, 41 Fed. Reg. at 51815 (SA8)). Furthermore, Section 32.7 of the regulations requires each

person engaged in the offer and sale of commodity options to maintain pertinent books and records, as therein specified, relating to the solicitation and the accounts of option customers. Id. at 51816 (SA9).

While recognizing that the financial, segregation and other requirements imposed by the regulations upon persons wishing to engage in the commodity options business were viewed by some commentators as anticompetitive in some respects, the Commission stated that it had considered the public interest to be protected by the antitrust laws and had concluded that the regulations in the form adopted were consistent with the requirements of Section 15 of the Act, 7 U.S.C. §19 (Supp. V, 1975) that the Commission endeavor to take the least anti-competitive means of achieving the Act's purposes 41 Fed. Reg. at 51809-10 (SA2-3).

In the Federal Register notice publishing the regulations, the Commission also determined that all provisions of the regulations would become effective 15 days after publication--i.e., on December 9, 1976), with the exception of the segregation requirement in Section 32.6, which would be made effective after the passage of 30 days on December 27, 1976, the Commission affirmatively found that the public interest required that the rules be adopted without any further delay "inasmuch as the public has been without the protection of a comprehensive regulatory program in an area which has historically been fraught with abuse" and because "affected persons have had an adequate opportunity, through prior notices, to take the necessary steps to be in full compliance with the rules by" the specified effective dates. Id. at 51817 (SA10).

ARGUMENT

The regulations governing commodity option transactions which are in issue before this Court, reflect the Commission's considered judgment as to the appropriate method for regulating commodity option transactions. As we have shown, supra, pp. 24-28, the Commission's determination was made after extensive study of the offer and sale of commodity options in the United States, a process which has consumed substantial Commission resources and has involved broad public participation--including participation by or on behalf of the plaintiffs.

The provisions that plaintiffs challenge before this Court are precisely those that will provide the safeguards the Commission has determined to be essential to provide adequate customer protection: making it unlawful for any person to accept money from an option customer without registration as a futures commission merchant (§32.3, SA7); imposing minimum financial requirements on registered futures commission merchants who will deal in options (amended §1.17, SA7); requiring adequate disclosure to option customers (§32.5, SA8); and requiring segregation of the purchase price paid by an option customer (§32.6, SA8).

Nevertheless, in the court below and before this Court, plaintiffs assert (B. Br. 35, 46, N. Br. 10) that the Commission's adoption of regulations governing commodity option transactions was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." See 5 U.S.C. §706(2)(A) (1970). It has been recognized, however, that:

"[r]ule makers, as the delegates of legislative power, are no more likely than their delegators to make every-

body happy with a particular exercise of that power. [The court's] . . . function is to see only that the result is reasonable and within the range of authority conveyed, that it has been formulated in the manner prescribed, and that the disappointed have had the opportunity provided by Congress to try to make their views prevail."

Automotive Parts & Accessories Association, Inc. v. Boyd, 407 F.2d 330, 343 (D.C. Cir. 1968). Thus,

" . . . the court must consider whether the [Commission's] decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment. . . . Although this inquiry into the facts is to be searching and careful, the ultimate standard of review is a narrow one. The court is not empowered to substitute its judgment for that of the agency." 46/

Accordingly, for the district court to have set aside administrative action as arbitrary and capricious, the party challenging the action must have proven that it was "willful and unreasoning action, without consideration and in disregard of the facts or circumstances of the case" 47/

46/ Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971) (citations omitted). See also, Wong Wing Hang v. Immigration and Naturalization Service, 360 F.2d 715, 718 (2d Cir. 1966); In Re Josephson, 218 F.2d 174, 182 (1st Cir. 1954), both cited with approval in Citizens to Preserve Overton Park Inc. v. Volpe, *supra* at 416. Accord, Bowman Transportation, Inc. v. Arkansas-Best Freight System, Inc., 419 U.S. 281, 284 (1974); Nader v. Sawhill, 514 F.2d 1064, 1067 (Tem. Emer. Cir. 1975); Environmental Defense Fund, Inc. v. Corps of Engineers of the United States Army, 470 F.2d 289, 300 (8th Cir. 1972); Rockbridge v. Lincoln, 449 F.2d 567, 572 (9th Cir. 1971).

47/ First National Bank of Fayetteville v. Smith, 508 F.2d 1371, 1376 (8th Cir. 1974), *cert. denied*, 421 U.S. 930 (1975). If a regulatory agency has articulated a rational connection between the facts found and the choices made, a reviewing court should "uphold a decision of less than ideal clarity if the agency's path may be reasonably discerned." Bowman Transportation, Inc. v. Arkansas-Best Freight Systems, Inc., *supra*, 419 U.S. at 284. See also, Burlington Truck Lines, Inc. v. United States, 371 U.S. 156, 168 (1962).

Under this standard of judicial review, the Commission's regulations must be sustained by this Court.

I. THERE IS NO BASIS IN FACT OR IN LAW FOR THE DISTRICT COURT TO HAVE ENJOINED ENFORCEMENT OF THE SEGREGATION PROVISIONS OF SECTION 32.6 OF THE COMMISSION'S COMMODITY OPTION REGULATIONS

A. The District Court Ignored the Record of the Commission's Rulemaking Proceeding which Provided Ample Support for the Commission's Decision to Impose a Segregation Requirement for the Protection of Commodity Option Customers.

As the record of the rulemaking proceeding demonstrates, supra, pp. 16-32, in order to protect against the prospect of domestic option dealer insolvency, Section 32.6 of the Commission's regulation was designed to require prompt segregation in the United States of 90% of the funds received by an option firm from each of its customers. These funds are to be treated by the firm as the property of the customer until the option has expired or has been exercised and all proceeds due the customer have been paid. As a result, in the event of the firm's insolvency the customer will at least be able to obtain return of most of the funds he advanced. The practical effect of this provision is to require an option firm to advance its own (or borrowed) funds for the account of its customer in order to acquire an option and to cover the firm's operating expenses until the option is exercised or lapses. Implicit in this requirement is an administrative judgment made by the Commission that, in view of the recurring abuses which have attended options transactions in this country, only those firms which are financially capable of implementing the protections of segregation should be allowed to solicit and to obtain funds from the public. As the Commission explained in its October 8, 1976 Federal Register notice

proposing the segregation provision:

" . . . in the Commission's view, what is of paramount importance is that option customers be assured, at the very least, that the assets which they put up to purchase the option will be safe during the term of the option and be available to be refunded to option customers in the event that an option customer exercises the option but is unable to obtain satisfaction of the obligations owing to him because of the insolvency of the futures commission merchant" 41 Fed. Reg. 44564 (SA15) (emphasis added).

The Commission further emphasized that by segregating assets in the United States "such assets will not be subject to the attachment or other laws or requirements of any other nation," id. (SA15), and that segregation will "help to prevent fraud" since, "[a]bsent segregation, these assets could be used by a person in its general operations . . . ," id. (SA15) In this regard, the rule is not significantly different in purpose than the requirements of Section 4d(2) of the Act, 7 U.S.C. §6d(2) (Supp. V, 1975), ^{48/} which was and is designed to protect the customers of futures commission merchants from similar contingencies with respect to their futures trading activities. ^{49/}

^{48/} Pursuant to Section 4d(2) of the Commodity Exchange Act, 7 U.S.C. §6d(2) (Supp. V, 1975), a futures commission merchant must segregate the funds of its futures customers.

^{49/} As stated by Senator Murray in the congressional debates on H.R. 6772, 74th Cong., 1st Sess. (1935) leading to the adoption of Section 4d(2) in 1936 as part of the original Commodity Exchange Act:

"This section merely provides that the public's money put up for margins shall be in fact treated as belonging to the customer, and held in trust

The recent failure of a large commission firm in Chicago finds that the public is holding the sack

(footnote continued)

To justify the injunction it entered against enforcement of this segregation provision, the court below asserted that the Commission did not appear to have adequately justified the segregation requirement, emphasizing the adverse financial burden which the court believed the segregation requirement would impose upon option dealers who act as "agents for London principals" and who, like plaintiffs, are required to transfer to London a substantial portion of the purchase price received from their customers (JA5, 512-5130. According to the district court, "[t]he only reason stated [by the Commission] for this admittedly harsh action was the need for speed to protect the public"; it stated that it had been unable to find "any reason or fact . . . which would seem to justify this need for haste." (JA513). In reaching these conclusions,

49/ (footnote continued)

for almost a million dollars in margin moneys."
80 Cong. Rec. 7858 (daily ed. May 25, 1936) (emphasis added).

Also, as stated by Senator Norris:

"The only purpose of the amendment is to protect money that is really a trust fund, sent to a commission agent and kept on deposit with him; to protect the margins of the customer and to prevent illegal use of the money for some other purpose." 80 Cong. Rec. 7911 (daily ed. May 26, 1936) (emphasis added).

The legislative history of the Commodity Futures Trading Commission Act of 1974 also recognizes the purpose of the segregation requirements of section 4d(2). As was noted in the House Report:

Brokerage firms hold large sums of money representing customers' margins. The use of such funds to finance the firms' own operations or the operations of favored customers could result in financial losses by other customers."

H.R. Rep. No. 93-975, Cong., 2d Sess. 68 (1974).

however, the court below plainly overlooked the Commission's express statement of the purposes to be served by segregation and ignored the undisputed basis in the rulemaking record upon which the segregation requirement could properly be considered by a reviewing court to be a reasonable exercise of the Commission's authority.

Thus, the indisputable history of fraudulent practices and insolvencies by commodity option firms in the United States, and the resulting losses to public investors, had indicated a particular need for the protections afforded by segregation.^{50/} In fact, during the very period during which the Commission was considering option regulations various firms dealing with London options were continuing to defraud the public and at least one of those firms--J. S. Love Associates--were placed into bankruptcy which appeared likely to result in substantial losses to investors who had purchased London options through that firm.

^{50/} The legislative history of this Act shows that Congress was concerned about the financial failure of firms' dealing in commodity options. See, e.g., H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 38, 37 (1974); see also Hearings on H.R. 11055 before the House Committee on Agriculture, 93d Cong., 2d Sess., Ser. 93-TT at 181-182, 194-196 (1974); Hearings on S. 2485, S. 2578, S. 2837 and H.R. 13113 before the Senate Committee on Agriculture and Forestry, 93d Cong., 2d Sess. pt. 1, at 224-225, pt. 3, at 682-683, 830-835 (1974) (testimony of Tom Maher and Glenn Willet Clark, and statement prepared by James Ryan and Richard Malm). See also, Securities and Exchange Commission v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Securities and Exchange Commission v. Univest, Inc., 405 F.Supp. 1057 (N.D. Ill. 1975), appeal pending, Civ. No. 76-1734 (7th Cir. 1976); Securities and Exchange Commission v. Norton, CCH Comm. Fut. L. Rep. ¶ 20,204 (N.D. Ill. 1976); Securities and Exchange Commission v. Williams, No. 76-1064 (10th Cir., Dec. 13, 1976); Glazer v. National Commodity Research & Statistical Service, Inc., 388 F.Supp. 1341 (N.D. Ill. 1974); In re Traders International, Ltd., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,529 (D. Nev. 1974); Securities and Exchange Commission v. Goldstein, Samuelson, Inc., Civil No. 73-472 (D.C. Cal. Oct 29, 1973) (Orders of permanent injunction by consent, under federal securities laws).

See Matter of J. S. Love & Associates Options, Ltd., Bankrupt, No. 76 B 590 (S.D. N.Y. May 20, 1976). The Commission's considerable enforcement experience in the options area,^{51/} to which the Commission specifically adverted in announcing the adoption of the interim rules containing the segregation requirement (41 Fed. Reg. 51808 at 51809, SA2) thus afforded specific factual support for the Commission's determination regarding segregation. See, e.g., Consumer's Union of United States v. Consumer Products Safety Commission, 491 F. 2d 810 (2d Cir. 1974).

Nevertheless, plaintiffs argue that the segregation requirement is unnecessary for the protection of option customers. On that basis they would have this Court conclude that the segregation requirement is unreasonable. Plaintiffs contend (B. Br 24, 25) that adequate protection is afforded to option customers in the United States by virtue of segregation effected in London and buy guarantees provided by London exchanges; they disingenuously assert that "the beneficial owner of the option is the true beneficiary of the guarantee mechanisms. . . ." (id. at 25).

^{51/} See, e.g., Commodity Futures Trading Commission v. First Commodity Corp. of Boston, Case No. 76-4051 M (D. Mass. 1976) (permanent injunction entered November 11, 1976); Commodity Futures Trading Commission v. Rosenthal & Co., Civil Action No. 76 C 3904 (N.D. Ill. 1976) (consent to preliminary injunction entered November 8, 1976); Commodity Futures Trading Commission v. American Options Corp., No. 75-3355 (C.D. Calif. 1975); Commodity Futures Trading Commission v. J.S. Love & Associates Options, Ltd., Civil Action No. 76-928 (DBB) (S.D.N.Y. 1976) (consent decrees entered March 1, 1976); Commodity Futures Trading Commission v. American Overseas Trading Corp., C-75-1970A (N.D. Ga. 1976) (permanent injunction entered October 15, 1976).

Contrary to plaintiffs' claims, however, no provision of domestic or foreign law, and no usage in the commodity option trade either here or in London, directly insures the funds of a customer in the United States against insolvency or wrongful acts by any of the persons who may become involved in the option transaction. This lack of customer protection--in the absence of the Commission's segregation requirement--is clearly established in the record of the rulemaking proceeding (see supra pp. 25-28). That record, which reflects information received from diverse sources within the option industry here and abroad, shows that funds received from option customers in the United States are not segregated for the customers' benefit either by option dealers in the United States or by the London exchanges or their members, and that the London exchanges do not provide a guarantee of performance which extends to the United States customer. Plaintiffs can cite nothing in the record to the contrary.

Plaintiffs' rely (B. Br. 26) upon their own "reference number" procedure, pursuant to which they claim that a customer--the beneficial owner of an option--may adequately pursue his rights to exercise an option through another firm. But the legal right they emphasize is illusory as a practical matter. Plaintiffs themselves admit that their London clearing broker who purchases an option for the plaintiffs' accounts will record the transaction on its book only in the plaintiffs' names and not in the name of plaintiffs' customers (B. Br. 10). This is confirmed by the record in the rulemaking proceeding, which shows that a principal-to-principal relationship exists between the option firm in the United States and the London clearing members (JA150-1520. A customer

would consequently be at a firm's mercy in seeking to pursue his rights against London brokers who are not even aware of his existence, much less aware that the customer is the beneficial owner of rights recorded in another's name. This difficulty would, of course, be compounded in the event of a firm's insolvency, since the customer would be required to pursue his rights through the bankrupt estate. It is this contingency--and not any of the other contingencies to which plaintiffs have primarily addressed their brief--which the segregation requirement has been designed to remedy.^{52/}

The court below also erred in assuming that the Commission had acted without having considered whether segregation could appropriately be applied to the option industry or the effect of segregation upon industry members (JA513). Specifically, the court asserted (JA512):

"There is nothing in the Advisory Committee report to suggest that it had considered whether ... a [segregation] requirement - which had originally been devised to apply to dealers in futures contracts who normally act as principals - could be appropriately applied to option dealers who, like plaintiffs, act only as agents." ^{53/}

^{52/} Of course, it may be possible for the customer of an insolvent option dealer to trace his property interest in specific commodity options purchased for his account through the bankrupt's estate and consequently obtain a greater return than the minimum assured through segregation. However, that prospect is by no means certain. See, e.g., Matter of J.S. Love & Associates Options, Ltd., Bankrupt, Bankruptcy No. 76 B 590 (S.D.N.Y. May 20, 1976).

^{53/} As noted above, pursuant to Section 4d(2) of the Commodity Exchange Act, 7 U.S.C. §6d(2) (Supp. V, 1975), a futures commission merchant must segregate the funds of its futures customers.

But, contrary to the district court's unsupported supposition (JA512), futures commission merchants do not act as principals, but act solely as agents, when acquiring futures positions for the accounts of their customers. In fact, it is unlawful for a futures commission merchant to offer a futures contract it has acquired for its own account to any person; a futures contract may lawfully be acquired for the account of a customer only through the facility of the exchange.^{54/} Since option dealers similarly act as agents for their customers--although many must act through intermediaries to obtain access to the London exchanges--the district court's analogy to futures activities tends to support the reasonableness of the Commission's imposition of a segregation requirement upon option dealers; it does not, as the district court erroneously seems to have assumed, involve a meaningful distinction that the Commission was required to explain.

In ruling that the Commission had acted with undue haste when it imposed a segregation requirement (JA513), the district court further relied upon erroneous beliefs that it was not until October 1976 that "the Commission . . . for the first time proposed . . . segregation" (JA512); that the Commission had earlier decided that segregation might well be inappropriate for those dealers who act solely as agents (JA508); and that "the concept of segregation was not specifically mentioned" in the Commission's October 1975 release soliciting public comment on several possible regulatory alternatives concerning commodity options (JA507). The district court also apparently found significance in the

^{54/} Section 4h, 7 U.S.C. §6h (1970).

fact that the rules proposed by the Commission on February 20, 1976, had contained no segregation provision (JA508, 513), and appears to have assumed (JA510)--contrary to fact--that the regulations subsequently proposed in October 1976 and adopted in November 1976 were merely modifications of the rule proposals that had been published in February.

As we have seen, however (supra p. 19), the Commission's October 22, 1975, release specifically raised the possibility of a segregation requirement in connection with the very kind of regulatory approach that is embodied in the rules adopted by the Commission in November 1976, which are at issue in the instant case. Moreover, the regulatory scheme proposed in February 1976 was very different from the regulatory scheme finally adopted. In sharp contrast to the final rules as adopted--which, since January 17, 1977, forbid a firm which writes options also to accept funds from the public--^{55/} the regulatory pattern suggested in the February 1976 proposals would have permitted an option dealer to both write and sell options to its customers--but to do so under stringent safeguards (see pp. 20-22 supra).

^{55/} Section 32.3, 41 Fed. Reg. 51814 (November 24, 1976) (SA7), requires that any firm which accepts money or property from a customer in connection with an option transaction register as a futures commission merchant. Under Commission Regulation 1.19, 17 C.F.R. §1.19 (1976), futures commission merchants are precluded from writing or otherwise assuming financial responsibility for the fulfillment of options.

In view of the protection otherwise afforded to customers under the February 1976 proposals, it was not, in the Commission's judgment, considered necessary also to require segregation of customer funds. It does not follow from this, however, as the district court erroneously assumed (JA508, 513), that a general segregation requirement is or was considered to be an unacceptable approach to investor protection ^{56/} under a different regulatory scheme--such as the one finally adopted.

It was in the context of the February 20, 1976, proposal that the Commission expressed a willingness to entertain an exemption from the net capital requirement ^{57/} for those option dealers who acted as agents for other dealers who wrote options--yet another matter to which the district court erroneously attributed significance (JA 508). - The Commission's willingness to consider an exemption ^{58/} under the rules then proposed, however, merely reflected the Commission's recognition that it was not necessary to impose stringent financial requirements on firms that acted solely as agents (and which, accordingly, would not be financially responsible for performance of the option) so long as the option writer

^{56/} Even with respect to the February 1976 proposals, the Commission did not find that segregation would be inappropriate for option dealers who acted as agents, as the Court seems to have believed (JA506). The Commission merely noted that it had decided not to impose segregation as part of the February proposals because of "difficulties involved in ascertaining which dealers should have been required to segregate" in light of other provisions then being considered. Nevertheless, as the court recognized in its opinion, the Commission requested specific comment on whether segregation should be imposed. 41 Fed. Reg. 7776 (February 20, 1976) (JA57).

^{57/} Proposed Section 32.10, 41 Fed. Reg. 7783-84 (February 20, 1976) (JA 64, 65).

^{58/} Proposed Section 32.3, 41 Fed. Reg. 7780 (February 20, 1976) (JA610).

maintained sufficient assets in the United States to fulfill its obligations under the option contract (which the February 1976 proposal would have required). Thus, to have obtained an exemption, the agent-dealers would have had to submit proof to the Commission that the option writer was registered with the Commission and had sufficient assets in the United States to meet the stringent net capital requirement. Since the writer of a London option does not normally maintain assets in the United States, however, under the February proposals option dealers offering London options in the United States would generally have been unable to obtain an exemption from the proposed net capital requirement.^{59/}

At the heart of the district court's erroneous analysis is its factual assumption that the burden imposed by the segregation requirement involves so great a hardship that option firms such as the plaintiffs "could not long remain in business if required to segregate in the United States an amount equal to 90% of . . . [the] funds advanced by customers," (JA514). There was, however, no evidence before the district court to support this finding. Indeed, the plaintiffs themselves appear generally unwilling to go that far; they argue merely that so-called smaller firms will not survive, suggesting that the field will unfairly be left only to larger firms "who are very willing to finance segregation." (B. Br. 30; see also JA443, 455). Thus, plaintiffs implicitly admit that the requirements of Section 32.6 are not incapable of being met--they recognize that firms can and will survive, and can and will meet the segregation requirements in doing so.

^{59/} 41 Fed. Reg. 7776 (February 20, 1976) (JA57).

To be sure, firms, small or large, which are inadequately capitalized in relation to the volume of option transactions being conducted may not be in a financial position to meet the segregation or other minimum financial requirements at present.^{60/} But the fact that certain members of an affected industry will be unable to meet an otherwise valid regulatory standard does not demonstrate that the regulation is arbitrary or capricious. See Bowles v. Willingham, 321 U.S. 503 (1954); Mulford v. Smith, 307 U.S. 38 (1939). Where, as here, the requirement will be clearly effective in achieving the legitimate purpose of protecting option customers, the fact that some financially precarious firms may be unable to comply is a reason why the rule is sound, not a reason why it may or should be rejected.

In another case, involving an analogous situation, the court below upheld the propriety of a regulatory scheme that imposed a harsher restriction on small collateral lenders who financed securities purchased on margin than were imposed on presumably larger banks and broker-dealers. Collateral Lenders Committee v. Federal Reserve System, 281 F.Supp. 899, 911-12 (S.D. N.Y. 1968). In that context, the court stated:

"The defendant does admit, and the Court recognizes, that there will be significant impact on the plaintiffs' business; indeed, that is the purpose of the regulation and it is undoubtedly true that compliance with Regulation G will require plaintiffs to readjust and reorganize their methods of doing business."

^{60/} Although, as the district court observed (JA516), plaintiffs contended that the segregation requirements would deplete their assets and thus prevent them from meeting the minimum financial requirements of the regulations, segregation of funds by the dealer does not in any way affect the computation of net capital required under Regulation 1.17 for such dealers. In computing net capital, the option dealer may include as a current asset customer funds which it places in segregation. See 17 C.F.R. §1.17(c)(2)(ii) and JA607.

But, rather than conclude that the regulation in issue was invalid because certain members of the affected industry would suffer irreparable injury from its requirements, the court emphasized the risk that the public would suffer irreparable injury in light of the threat to the investing public and the economy as a whole if the requirement were not sustained. See also Crimmins v. American Stock Exchange, Inc., 368 F.Supp. 270, 280 (S.D. N.Y. 1973). The district court in the instant case should have analyzed the administrative determination made by the Commission in a similar manner.

Moreover, while the district court in the case at bar considered it unreasonable that the Commission might compel an option dealer to advance its own funds or borrowed funds to pay the premium on an option it acquires for its customers' accounts (JA514), there is nothing remarkable about an agent advancing funds for the account of its principal. In fact, it is an everyday occurrence that securities brokers advance their own or borrowed funds to buy securities for margin account customers who, under Federal Reserve Board regulations, are permitted to pay only a certain percentage of the purchase price of securities, and who, under securities options regulations recently adopted, will be permitted to advance no part of the purchase price at all.^{61/}

^{61/} The extension of credit by brokers, dealers and members of the national securities exchanges is governed by Federal Reserve Board Regulation T. 12 C.F.R. Part 220 (1976). This regulation currently permits securities brokers to loan customers up to 50% of a security's current market value for the purpose of purchasing stock; 70% of the underlying market value of the security for purchasing an uncovered stock option; and 100% of the amount required to buy a covered stock option. See CCH Fed. SEC. L. Rep. ¶80,726 (1976)(publishing amendment to Regulation T adopted September 22, 1976, effective January 1, 1977).

Of course, there are differences between the purchase of securities on margin, which is voluntary on the part of the broker-dealer, and the acquisition of commodity options subject to a mandatory segregation requirement. What is essentially and significantly the same, however, is that in each situation the agent advances funds for the benefit of its customer, and we are aware of no basis upon which it may be claimed that securities brokers have suffered financially to the extent that they have advanced funds for their customers' accounts.

Moreover, while a securities broker-dealer may charge his customer interest for the funds advanced for the customer's account, the option dealer will be entitled, under Section 32.6, to retain the interest earned on segregated funds and may charge his customer for any excess of expenses over income that may be incurred in this process. Furthermore, under the 90% segregation provisions, the option firm will have the immediate use of 10% of the funds received from a customer—which will permit the firm immediately to defray finance and other charges. Broker-dealers may also hypothecate their interest in securities held on margin for the account of their customers. Presumably, an options dealer can assign as collateral, subject to customers' interests, its own contingent remainder interest in the segregated funds to which it will be entitled when the option expires or is exercised and the proceeds are sent to the customer.

Notwithstanding the comparability of plaintiffs' situation to that of numerous securities broker-dealer firms, the district court was not persuaded that it would be practical for an option firm to finance its business under the segregation requirement (JA524, n. 29). The court

below was apparently influenced by plaintiffs' insubstantial claim (which they again advance to this Court, B. Br. 30) that the difference between the interest they would have to pay and finance segregation the interest they could expect to earn and the segregated fund would roughly equal their net profit on each transaction.

But, accepting the plaintiffs' own figures (B. Br. 22), arguendo,^{62/} it is apparent that nothing more than a minor increase in the cost of doing business--which can easily be passed on to customers--would result from imposition of the segregation requirement. Plaintiffs claim that they will make a net-after-tax profit of \$82.66 on transactions in which a customer pays a purchase price of \$2,250. With respect to such an option, Section 32.6 would require plaintiffs to segregate \$2,025--90% of the \$2,250 purchase price. If plaintiffs were to borrow this amount for a 6 month option transaction, and were required to pay interest at a rate of 8 1/2% per year (which is a figure the plaintiffs suggest (B. Br. 23)), their interest expense would be \$86.07 for the six-month period. At the same time, however, the segregated fund of \$2,025 may be placed in an interest bearing account, and the option dealer (plaintiff) will be entitled to retain the interest that account earns. Even at 6% interest,^{63/} the account would earn \$60.75 in 6 months.

^{62/} These figures, upon which the plaintiffs heavily rely (B. Br. 22), are derived from financial statements annexed to the affidavit of John Forma, submitted to the court below. Those financial statements are not certified and Mr. Forma does not even purport to vouch for their accuracy in the affidavit to which they were attached.

^{63/} Section 32.6 also permits the segregated fund to be invested in certificates of deposit and U.S. government obligatus, providing the dealer with even a greater rate of interest.

Thus, the net cost of segregating would be a mere \$25.32 for an option costing \$2,250. In the unlikely event a plaintiff did not pass the cost on to its customer it would still be making a profit of \$57.34 after payment of all sales commissions, executive salaries and other expenses. If the plaintiffs were unwilling to absorb this cost (and there is no reason why they should), they could presumably increase the cost of the option to their customer by about 1-1/4% and obtain the same level of profits they currently claim to enjoy. Thus, using plaintiffs' own figures, it is apparent that there is no proof of any substantive harm; at most the plaintiffs will have to modify their method of doing business in order to meet the regulatory requirements.

The law requires that an administrative agency's regulations must have an adequate basis in law and fact and that they be reasonably related to the regulatory objectives properly to be served. If it may be found that the agency took a reasonable approach--albeit not necessarily the approach that a reviewing court might have chosen--the regulation must be sustained. See, e.g., General Transportation Co. of Southwest v. United States, 449 F.2d 846, 82 (5th Cir. 1971); Automotive Parts & Accessories Assn. v. Boyd, 407 F.2d 330, 343 (D.C. Cir. 1968), cited with approval, National Nutritional Foods Assn. v. Weinberger, 512 F.2d 688 (2d Cir. 1975).

Protection of option investors is unquestionably a Congressional objective to be implemented by the Commission under the Act. Moreover, as we have shown, the segregation requirement is reasonably designed to provide the measure of investor protection that is not otherwise available. In these circumstances adoption of the segregation provision

satisfies the requisite standard for agency action. There is no further requirement, as the district court seemed to suggest (JA513), and as the plaintiffs argue (B. Br. 29-30) that the Commission, having found a satisfactory means to meet its regulatory objectives, must divert its limited resources to a continuing search for other alternatives. Cf. Bunny Bear, Inc. v. Peterson, 473 F.2d 1002, 1007 (1st Cir. 1973); Angel v. Butz, 487 F.2d 260, 263 (10th Cir. 1973). Because the responsibility to choose among regulatory alternatives has been entrusted by law to the Commission, the Commission was at most required to explain why it did not choose to accept suggestions the commentators--including the plaintiffs--had advanced.^{64/} This the Commission has done. See 41 Fed. Reg. 51812 (SA^{65/}5). There is no basis in law upon which it may be compelled to do

^{64/} See, e.g. Automotive Parts & Accessories Assn. v. Boyd, 407 F.2d 330, 338 (D.C. Cir. 1968); National Nutritional Foods Ass'n v. Weinberger, 512 F.2d 688 (2d Cir. 1975). See also Alabama Association of Insurance Agents v. Board of Governors of Federal Reserve System, 533 F.2d 224, 236-37 (5th Cir. 1976); Public Service Com'n v. Federal Power Com'n, 467 F.2d 361 (D.C. Cir. 1972). Florida Sugar Cane League, Inc. v. Usery, 531 F.2d 299 (5th Cir. 1976).

^{65/} A number of alternatives to segregation were proposed, such as insurance, letters of credit, bonding and other forms of financial guarantees. The primary reason why none of the proposed alternatives was adopted in lieu of segregation was that "specific proposed alternatives had not yet been submitted," and it was not readily apparent that the proposals suggested were susceptible of implementation. (41 Fed. Reg. 51812 (November 24, 1976) (SA^{65/}5)). Thus, for example, such proposals as bonding or protection through letters of credit could be evaluated only on a case-by-case basis, since the availability of protection in that form would necessarily vary from firm to firm.

Through the adoption of Section 32.4(b) of its option rules, the Commission indicated its willingness to grant exemptions from the segregation requirements on a case-by case basis if a firm can show that it can implement any of the alternatives urged by the

more, and no basis in fact why it should.

The Commission made a permissible regulatory judgment that segregation was an effective approach to provide protection for the public. In this context it was wholly inappropriate for the district court to have concluded the public should be denied protection during an indefinite period, because of the alleged possibility of an adverse effect on plaintiffs. Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971); Automotive Parts & Accessories Association, Inc. v. Boyd, 407 F.2d 330, 343 (D.C. Cir. 1968); First National Bank of Fayetteville v. Smith, 508 F.2d 1371, 1376 (8th Cir. 1974), cert. denied, 421 U.S. 930 (1975).

- B. The District Court Was Not Entitled to Issue a Preliminary Injunction Against Enforcement of The Segregation Requirement On the Basis of the Record Before It.

A preliminary injunction is an extraordinary and drastic remedy and may be granted only upon a clear showing that plaintiffs will suffer irreparable injury if the injunction is not granted, that they are likely to prevail on the merits, and that their injury clearly outweighs any foreseeable injury to the public interest from granting

65/ (footnote continued)

commentators--or any alternative not previously proposed--in a manner that would provide a substitute for segregation which would be adequate to provide the regulatory protections that segregation affords. 41 Fed. Reg. 51812 (November 24, 1976) (SA5). Significantly, the record below is devoid of any evidence that plaintiffs had, or could present, individually or collectively any effective substitute for segregation.

the injunction.^{66/} The burden of proof rests on the moving party and that burden is substantial. Robert W. Stark, Jr., Inc. v. New York Stock Exchange, Inc., 466 F.2d 743, 744 (2d Cir. 1972); Sierra Club v. Hickel, 433 F.2d 24, 33 (9th Cir. 1970, aff'd on other grounds, 405 U.S. 727 (1972)); Berrigan v. Norton, 451 F.2d 790, 793 (2d Cir. 1971); Crowther v. Seaborg, 415 F.2d 437, 439 (10th Cir. 1969); Garlock, Inc. v. United Seal Incorporated, 404 F.2d 256, 257 (6th Cir. 1968); American Basketball Association v. National Basketball Association, 404 F.Supp 832 (S.D.N.Y. 1975); Kontes Glass Company v. Lab Glass, Inc., 250 F.Supp. 193, 195 (D.C. N.J. 1966), aff'd, 373 F.2d 219 (3rd Cir. 1967).

Notwithstanding plaintiffs' heavy burden, however, the affidavits and other materials submitted in support of their prayer for injunctive relief contain virtually no probative evidence in support of alleged irreparable injury or in support of their claim of arbitrary or capricious action by the Commission. Instead, their moving papers are replete with conclusory assertions and hearsay statements. Similarly, their briefs before this Court are replete with factual assertions and bare conclusions, but are devoid of meaningful reference to the record--an implicit admission that the record below does not contain evidence in support of their claims.

66/ Burns v. Paddock, 503 F.2d 18, 28 (7th Cir., 1974); Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Company, Inc., 476 F.2d 678 (2d Cir. 1973); Clairol, Inc. v. Gillette Co., 389 F.2d 264, 265 (2d Cir. 1968); Virginia Petroleum Jobbers Association v. Federal Power Commission, 259 F.2d 921 (D.C. Cir., 1958). See generally, Wright & Miller, 11 Federal Practices and Procedure §2948; 7 Moore's Federal Practice para. 65.04.

For example, the "evidence" plaintiff adduced before the district court to show that the segregation requirement would result in their being unable to continue in business consists almost exclusively of wholly unsupported claims that the regulations are "totally unsuitable to the industry"; "survival will be impossible"; and that "plaintiffs will be forced out of business." Plaintiffs would now have this Court accept their injury as an article of faith, repeatedly claiming that their injury is "obvious," but never seriously attempting to demonstrate why this is so. (See B. Br. 21, 36, N. Br. 23, 24, JA450, JA636).

Although several of plaintiffs' officials offered analyses in a superficial attempt to show the effect of the segregation requirement, plaintiffs tendered no certified financial statements or even unaudited, but verified, financial statements reflecting their actual business activities. There is no explanation in the record below or in their briefs on this appeal why they were unable or unwilling to provide in a meaningful form financial information so basic to their request for extraordinary relief. And, as we have seen (supra pp. 50-51) the financial information plaintiffs have proffered, which is based entirely on an unverified income statement, reflects that segregation will not materially affect their net profits and would, at most, result in a significant increase in the purchase price of options they offer.

67/ Affidavit of John Forma (JA494).

68/ See, e.g., JA442, 550, 492.

Moreover, the record is devoid of any evidence of efforts the plaintiffs may have made to obtain capital or to arrange debt financing to meet the segregation requirements or whether such attempts were unavailing and why. In these circumstances there was no basis upon which the district court could properly assume that any plaintiff would suffer any significant adverse effect from the segregation requirements, much less assume, as it did, that they could not long remain in business (JA15).

Mere self-serving speculation that irreparable injury will result--which is all the record at bar contains--is not a permissible basis upon which administrative action may be enjoined. Hannah v. Larche, 363 U.S. 420, 443 (1960). "Unadorned speculation will not suffice to invoke the federal judicial power" in any case. Simon v. Eastern Ky Welfare Right Organization, 96 S. Ct. 1917, 1927 (1976). See also Udall v. D.C. Transit System, Inc., 404 F.2d 1358 (D.C. Cir. 1968); A.O. Smith Corp. v. Federal Trade Commission, 530 F.2d 515 (3d Cir. 1976). As the court observed in Hershey Creamery Co. v. Hershey Chocolate Corp., 269 F.Supp. 45, 59 (S.D.N.Y. 1967):

"The issuance of an injunction is not justified by the mere fact that irreparable harm may possibly ensue if restraint is not imposed. The plaintiff must make out a case for the issuance of an injunction by demonstrating that there is a clear present need for it. Injunctions will not be issued merely to allay the fears and apprehensions or to soothe the anxieties of the parties. . . ."

To the extent plaintiffs were required to show that the possible harm to their private interests outweighed the injury to the public interest resulting from the issuance of an injunction, plaintiffs

similarly failed to satisfy their burden. Although the district court found (JA514) that the public interest would not be adversely affected because of the other aspects of the Commission's regulations which were in effect and were about to go into effect, none of these other provisions serve to insure that a public customer can obtain a return of his initial investment in the event of the dealers insolvency. The district court failed to recognize that the segregation provision is the linchpin of the regulatory scheme under which the Commission determined to permit options transactions to continue in this country; the other regulatory provisions were designed to complement segregation. For example, the standard and computation of net capital was made less stringent than in earlier proposals because a segregation requirement was included in the scheme. The effect of the injunction against segregation is thus to allow inadequately capitalized firms to operate with the consequent risk to the public of insolvency. As the court stated in Virginia Petroleum Jobbers Association v. Federal Power Commission, 259 F.2d, 921, 925 (D.C. Cir. 1958), "[T]he interests of private litigants must give way to the realization of public purposes."

Plaintiffs' affidavits are likewise devoid of competent evidence concerning their claims on the merits of the segregation requirement. Insofar as the district court relied upon plaintiffs' unsubstantiated averments that the segregation was unnecessary because the guarantees and "segregation" in London inure to the benefit of option customers in the United States and, in the event of a plaintiff's insolvency, customers may exercise their options through another dealer, that was plainly wrong. These assertions were advanced without personal knowledge,

rest on pure hearsay, and, could not have established a prima facie showing for injunctive relief in view of the direct evidence in the record and plaintiffs' own admissions to the contrary (see supra, pp. 23, 28, n. 43). See Reeves v. American Optical Co., 408 F.Supp. 297 (W.D.N.Y. 1976).^{69/}

In any event, since the Commission unambiguously disputed all of plaintiffs' claims of injury, the district court was required to hold an evidentiary hearing on that issue rather than rely solely on affidavits. See Securities and Exchange Commission v. Frank, 308 F.2d 486 (2d Cir. 1968) (preliminary injunction reversed for failure to afford defendant a hearing). Accord, Sims v. Greene, 161 F.2d 87, 88 (3d Cir. 1947), cited with approval in Dopp v. Franklin National Bank, 461 F.2d 873, 879 (2d Cir. 1972). The district court refused to give the Commission an opportunity for an evidentiary hearing, although it recognized its importance:

"The strongest showing the Commission makes [on motion for reconsideration] is that I should have taken testimony on the question of irreparable damage but for me to waste time doing that at this point would be, as far as I can see, in the last degree idiotic because the question needs to get decided and needs to get decided as fast as possible whether this regulation is valid or whether it isn't valid, not whether this particular plaintiff is injured by it or not.

The prejudicial impact of the district court's abdication of its responsibility to weigh conflicting evidence in a meaningful manner is, of course, compounded by the fact that, as we have shown, plaintiffs' presentation is devoid of evidentiary substance, while the Commission

^{69/} See, e.g., Affidavit of Charles J. Hecht, JA335; Affidavit of James Carr, JA496.

^{70/} Transcript of January 12, 1977, JA618.

submitted for the district court's consideration the comprehensive record of the rulemaking proceeding upon which the challenged regulations were adopted--the factual content of which was not seriously disputed by the plaintiffs in any material particular.

II. THE DISTRICT COURT CORRECTLY UPHELD ON SUMMARY JUDGMENT
THE VALIDITY OF ALL OTHER PROVISIONS CONTAINED IN THE
COMMISSION'S COMMODITY OPTION REGULATIONS.

A. The Court Below Correctly Held that the
Commission Complied Fully With All Applicable
Statutory and Constitutional Requirements in
Adopting Its Option Regulations.

In sustaining the validity of all of the Commission's option regulations other than the segregation provision, the district court concluded (JA515) that there was no merit to any of plaintiffs' claims that the Commission had violated procedural requirements of the Administrative Procedure Act ("APA") or the Commodity Exchange Act. The court below found (JA515-516) that adequate notice and opportunity to comment on each of the provisions contained in the rules had been afforded in accordance with the notice and comment provisions of 5 U.S.C. §553. It also ruled (JA516) that the Commission had been entitled to make certain of the regulations effective less than 30 days from publication of their adoption because, in accordance with 5 U.S.C. §553(d), the Commission had found and had published with the rules a statement of "good cause" for making those regulations effective in 15 days.

These determinations were clearly supported by the record of the Commission's rulemaking proceeding. Thus, as we have previously shown (supra 15-30), the Commission originally provided broad public notice of the general subject and purpose of its proposed rulemaking and, subsequently, gave notice of particular rules it proposed to

adopt. Specifically, in its release of October 22, 1975, the Commission announced that it was considering the adoption of rules to regulate--or to ban--trading in commodity options, and provided an extensive description of the subjects, issues and alternatives involved in its consideration of that matter. Its later public release of February 20, 1976, detailed and explained the terms of specific rules that were then proposed to be adopted, and an oral hearing was thereafter held on March 8, 1976, for the presentation of views of members of the public. In addition, after full consideration of all the comments that had previously been presented, and after full consideration of the report of its Advisory Committee, the Commission on October 8, 1976, announced and discussed rule proposals which, after further opportunity for public comment, were finally adopted substantially in the form proposed.

At each step of the rulemaking process interested persons were invited to, and did submit comments both on the regulatory approaches suggested and on the specific terms of the proposed rules. And public participation was substantial (see SA2). In addition to the broad public involvement in the deliberations of the Advisory Committee, the Commission itself received numerous letters of comment in response to the public notices it had issued. In fact, as we have seen (supra p. 23, 27), plaintiffs' counsel took an active role in the oral hearing held on March 8, 1976, and also submitted comment letters on November 4, 1976, addressed to the Advisory Committee, and on November 8, 1976, in response to the Commission's request for comments on its definitive October 8, 1976, proposals (JA20, 805).

Notwithstanding the foregoing, plaintiffs continue to assert (B. Br. 28, 51, 53; N. Br. 17-19) that adequate public participation was not provided in the rulemaking process. They claim (B. Br. 53) that all of the public comments prior to the publication of the Commission's proposed regulations on October 8, 1976, were meaningless since earlier proposals were completely different. They further assert (B. Br. 50) that an oral public hearing--in which the affected industry could "educate" the agency--was not held on the regulations even though Section 4c(b) of the Act provides that options regulations may be promulgated only "after notice and opportunity for hearing."

But, as the court below correctly observed (JA515), "[t]he Administrative Procedure Act does not require that the rules adopted be identical to those proposed." California Citizens Band Association, Inc. v. United States, 375 F. 2d 43 (9th Cir. 1967); accord, South Terminal Corp. v. Environmental Protection Agency, 405 F. 2d 646 (1st Cir. 1974); International Harvester Company v. Ruckelshaus, 478 F. 2d 615, 632 (D.C. Cir. 1973); Logansport Broadcasting Corp. v. United States, 210 F. 2d 24 (D.C. Cir. 1954). Indeed, under 5 U.S.C. §553 there is no requirement that the precise text of a rule be published for comment before it can be adopted; it is sufficient that the agency set forth in its announcement of proposed rulemaking the nature of the subjects and issues involved.^{71/} This the Commission did in October

^{71/} Plaintiffs' citation (B. Br. 50) to Texaco Inc. v. Federal Power Commission, 412 F. 2d 740 (3d Cir. 1969) and National Labor Relations Board v. Wyman-Gordon Co., 394 U.S. 759 (1969) is completely misplaced. In each of those cases the agencies there involved had provided no notice whatsoever prior to adopting rules.

1975; accordingly, that notice alone would have sufficed. Nevertheless, the Commission sought additional public comments as well. It did so first in connection with specific rule proposals in February 1976, involving a type of regulatory approach it was persuaded to abandon. It did so again in connection with its October 8, 1976, proposed regulations, which, as modified to meet valid suggestions, were ultimately adopted. This reflects a degree of public participation far in excess of the minimum contemplated by the Administrative Procedure Act.

Contrary to plaintiffs' erroneous assumption, the language of Section 4c(b) of the Commodity Exchange Act, which refers to a "hearing" does not mandate that an oral hearing must be held before the Commission may adopt option regulations. In United States v. Florida East Coast Railway Co., 410 U.S. 224 (1973), the Supreme Court expressly held that a similar statutory requirement that the Interstate Commerce Commission to adopt certain rules only "after hearing" imposed no greater obligation on that agency than to comply with the standards for notice and opportunity for written comment established under the Administrative Procedure Act. The Court held, 410 U.S. at 241, that a statutory "hearing" requirement does

"... not by its own force require the Commission either to hear oral testimony, to permit cross-examination of Commission witnesses, or to hear oral argument."

Similarly, in United States v. Allegheny-Ludlum Steel Corp., 406 U.S. 742, 758 (1972), the Court addressed the same statutory provision and upheld rules of the Interstate Commerce Commission, holding

holding that the rulemaking

" . . . proceeding . . . was governed by the provision of 5 U.S.C. §553 of the Administrative Procedure Act, requiring basically that notice of proposed rulemaking shall be published in the Federal Register, that after notice the agency give interested persons an opportunity to participate in the rulemaking through appropriate submissions, and that after consideration of the record so made the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. The 'Findings' and 'Conclusions' embodied in the Commission's report fully comply with these requirements, and nothing more was required by the Administrative Procedure Act." 72/

There is likewise no merit to plaintiffs' contention (B. Br. 52, N. Br. 13-14) that the court below was not entitled to accept at face value the reasons stated by the Commission for having made certain provisions of the regulations effective 15 days after publication. 73/

72/ The Allegheny case is also dispositive of plaintiffs' further suggestion (B. Br. 4, 17) that the district court should have considered whether the Commission's action was "unsupported by substantial evidence. . . ." The provision upon which plaintiffs rely, 5 U.S.C. §706(2)(E) (1970), expressly authorizes this standard of review only in "a case subject to Sections 556 and 557" of Title 5 of the United States Code--which prescribe a form of hearing that is normally appropriate only for adjudicative matters. In Allegheny-Ludlum Steel Corp., supra, 406 U.S. at 757, the Court explicitly held:

"Sections 556 and 557 need be applied 'only where the agency statute, in addition to providing a hearing, prescribes explicitly that it 'be on the record.'" Siegel v. Atomic Energy Commission, 130 U.S. App. D.C. 307, 314, 400 F. 2d 778, 785 (1968). . . ."

In that case, as in the case at bar, it was not enough to invoke those provisions where the statute merely referred to an opportunity for a hearing.

73/ 5 U.S.C. §553(d)(3) (1970). In any event, this issue is moot since the 30-day period since the publication of the regulations November 24, 1976--which is designed to give the public notice

(footnote continued)

The court's position was fully in accord with applicable authorities. See People of State of California, State Lands Commission v. Simon, 504 F. 2d 430 (T.E.C.A. 1974), cert. denied, 419 U.S. 1021 (1974). Clay Broadcasting Corp. of Texas v. United States, 464 F. 2d 1313 (5th Cir. 1972) rev'd on other grounds, 415 U.S. 336 (1974); Buckeye Cablevision Inc. v. Federal Communications Commission, 387 F. 2d 220 (D.C. Cir. 1967). Plaintiffs offered no evidence that even, arguably, raised a genuine dispute as to the Commission's rational.⁷⁴

73/ (footnote continued)

of the implementation of a regulation--elapsed on December 23, 1976, over a month ago. The failure of an agency to demonstrate good cause for shortening the 30-day period does not render the regulations null and void after the 30-day period has elapsed but only affects the validity of the regulation during the 30-day period. See Lewis--Mota v. Secretary of Labor, 469 F. 2d 478 (2d Cir. 1972).

74/ The Commission explained why it was deemed necessary and appropriate to make certain of the regulations effective within 15 days and why, in light of prior notice and publication of these provisions, no person could reasonably claim to have been prejudiced by that action. The Commission stated:

"In order to assure full and fair consideration of the various proposals that have been made over the many months in which option regulations have been considered, it has not been possible to implement appropriate regulations before now. That consideration having now been completed, however, the Commission finds that the public interest requires that the foregoing rules be adopted without any further delay inasmuch as the public has been without the protection of a comprehensive regulatory program in an area which historically has been fraught with abuses. Moreover, there has been ample notice and public participation in this rule-making proceeding and affected persons have had adequate notice and opportunity to comment on the subject of these

(footnote continued)

Plaintiffs now attempt to show (B. Br. 51) that the public was not adequately notified in October 1976—claiming that members of the public had been led to believe that the Commission intended to hold an oral public hearing in December before final adoption of the interim regulations. That claim, however, is untenable. At no time did the Commission announce that it would hold an oral hearing before adopting regulations in November; the proposed oral public hearing to which plaintiffs refer was one which was contemplated with respect to the second stage of the regulatory scheme and, consequently, one which may yet be held (see JA491).

The Commission's compliance with the rulemaking provision of the Administrative Procedure Act also satisfies the requirements of constitutional due process. In California Citizens Band Association v. United States, 375 F.2d 43, 50 (9th Cir. 1967), for example, it was recognized that there is no

" . . . constitutional requirement, under the Due Process Clause of the Fifth Amendment, or otherwise, for public evidentiary hearings in connection with such rulemaking . . . 'Bowles v. Willingham, 321 U.S. 503, 519. . . .' (1943)."

Nor are the constitutional requirements of due process violated merely because the regulation that an agency adopts may impose a heavier burden on one party than another. In fact, many companies--and even whole

74/ (footnote continued)

rules and the issues involved in their consideration, as well as the terms of the rules themselves substantially as adopted. Furthermore, affected persons have had an adequate opportunity, through prior notices, to take the necessary steps to be in full compliance with the rules by the effective dates thereof." 41 Fed. Reg. 51817 (SA ____).

industries--have been forced out of business by governmental regulation without there being any denial of due process. See Bowles v. Willingham, 321 U.S. 503 (1943); Mulford v. Smith, 307 U.S. 38 (1939). In upholding regulations of the Federal Price Control Administration, the Supreme Court stated in Bowles v. Willingham, *supra*, 321 U.S. at 518:

"A member of the class which is regulated may suffer economic losses not shared by others. His property may lose utility and depreciate in value as a consequence of regulation. But that has never been a barrier to the exercise of the police power. . .".

Plaintiffs passingly suggest (B. Br. 36; N. Br. 24) and the district court remarked (JA513-514) that Section 4c(b) might be invalid because, taken out of the statutory context in which it is found, Section 4c(b) does not appear to contain any standards to guide the Commission in the exercise of its regulatory responsibility. But even if this view had merit--which it plainly does not--^{75/} it overlooks the fact that the Commission's authority to adopt rules to implement the statutory purposes and provisions (including those reflected in

^{75/} The Supreme Court has recognized that the Constitution "has never been regarded as denying to the Congress the necessary resources of flexibility and practicality . . . to perform its functions." Currin v. Wallace, 306 U.S. 1 at p. 15 (1939). Thus, it has held:

"Only if we could say that there is an absence of standards for the guidance of the Administrator's action, so that it would be impossible in a proper proceeding to ascertain whether the will of Congress has been obeyed, would we be justified in overriding its choice of means for effecting its declared purpose" Yakus v. United States, 321 U.S. 414, 426 (1944).

And, significantly, the legislative history of an act is an appropriate vehicle to determine that Congress has provided standards. Id. at 431.

Section 4c(b)) is granted by Section 8a(5) of the Act, 7 U.S.C. §12a(5), which contains standards the adequacy of which can hardly be doubted.

This is significant because standards established in a statute are to be taken as a whole and are not to be tested individually in isolation. Thus, the standards to be applied in the delegation of authority contained in Sections 4c(b) and Section 8a(5), derive meaning and content from the purpose of the Act, its factual background and legislative history, the substance of which has been set forth supra, and the meaning of which, as applied to option regulations, is not in any sense ambiguous. See American Power & Light Co. v. Securities and Exchange Commission, 329 U.S. 90 (1946); Fahey v. Mallonee, 332 U.S. 245 (1947); Lichter v. United States, 334 U.S. 742 (1948).^{-76/}

^{76/} Particularly in view of the relevant statutory context and legislative history, the suggestion that Section 4c(b) might successfully be challenged has the hollow ring of another era. See Yakus v. United States, 321 U.S. 44 (1944). See also, United States v. Grimaud, 220 U.S. 506 (1910); United States v. Atchison, Topeka & Santa Fe Railway Co. et al., 234 U.S. 476 (1913); New York Central Securities Corp. v. United States, 287 U.S. 12 (1932); Fahey v. Mallonee, 332 U.S. 245 (1947); Hirabayashi v. United States, 320 U.S. 81 (1943); 332 U.S. 245 (1947); Lichter, et al. v. United States, 334 U.S. 742 (1948); Wisconsin, et al. v. Federal Power Commission, 373 U.S. 294 (1963). In fact, there appear not to have been any Supreme Court rulings holding an unconstitutional delegation of legislative power to have been made because of inadequate standards, since Schechter Corp. v. United States, 295 U.S. 495 (1935) and Panama Refining Co. v. Ryan, 293 U.S. 388 (1935) invalidated provisions of the National Industrial Recovery Act of 1933. See Amalgamated Meat Cutters and Butchers Workmen of North America, AFL-CIO v. Connally, 337 F. Supp. 737 (1971).

B. The Court Below Correctly Held that the Commission Adequately Considered the Competitive Implications of Its Action in Accordance With the Requirement of Section 15 of the Act.

Plaintiffs attack the option regulations as having been adopted in violation of Section 15 of the Act, 7 U.S.C. §19 (B. Br. 30,31, 39,42,43; N. Br. 20-22) and as being anticompetitive in violation of the antitrust laws. In promulgating any rule, the Commission is required by Section 15 to

" . . . take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of [the Commodity Exchange Act], as well as the policies and purposes of (the Commodity Exchange Act]"

Plaintiffs specifically challenge as anticompetitive the Commission's minimum financial and disclosure requirements because similar requirements-- and the attendant expenses--are not imposed on persons dealing in commodity futures contracts. They suggest (B. Br. 2) that the Commission's antifraud rule alone would be sufficient to achieve the statutory purposes and, accordingly, would be the least anticompetitive means of achieving those purposes.

But participants in the futures industry have long been required to sustain the cost of a pervasive regulatory scheme, which is necessarily reflected in the fees they must charge their customers. Thus, rather than seek competitive equality, plaintiffs seek in fact to retain the competitive advantage they have enjoyed in the absence of regulation.

Moreover, the Commission has determined that its antifraud rule alone is not adequate to achieve the customer protection objectives of the Act; this judgment is determinative under Section 15, and plaintiffs have no right to have their view substituted for the Commission concerning this issue.^{77/} Even when the Antitrust Division of the

^{77/} Comment letters on the proposed rules raised similar objections to that now being raised by plaintiffs. The Commission considered those comments in adopting the regulations and addressed those comments in the release accompanying those rules:

"Many of the persons who commented on the Commission's proposal of October 8, 1976, maintained that the Commission's proposal was anti-competitive in various respects: that it imposed stricter standards on persons dealing in commodity options than are presently imposed on persons dealing in commodity futures contracts; that it discriminated unfairly between futures commission merchants dealing in commodity options and futures commission merchants dealing in commodity futures contracts; and that it required disclosures to prospective option customers that are not required to be made to prospective customers dealing in commodity futures contracts. In proposing and in adopting the interim rules, the Commission has taken into account its responsibilities under Section 15 of the Act, 7 U.S.C. §19 (Supp. V, 1975), and has determined that the options regulations in the form proposed and as adopted meet the requirements of that Section. . . . While the Commission is mindful that the financial, segregation and other criteria imposed as prerequisites to allowing a person to enter into or continue in the commodity options business may result in some lessening of competition, in its judgment, the interim rules are necessary to effectuate an essential purpose and policy of the Act: That is to require that the Commission provide essential customer protections which would attempt to assure the financial solvency of option transactions and prevent fraud. As a result, rules have been adopted, particularly in the areas of registration, disclosure, segregation and minimum working capital, which are intended to provide such customer protections as are

(footnote continued)

Department of Justice seeks to impose its view of relevant anti-competitive considerations upon an independent regulatory agency, the Supreme Court has recognized that the responsibility for weighing this factor along with other relevant considerations is for the agency alone. As stated in Northern Lines Merger Cases, 396 U.S. 491, at 513-514 (1970):

"The Department [of Justice] urges that the [Interstate Commerce] Commission failed to give sufficient weight to the diminution of competition between the Northern Lines--in short, that it failed to strike the correct balance between antitrust objectives and the overall transportation needs that concern Congress. This contention tends to isolate individual factors that are to enter into the Commission's decision and view them as controlling considerations. 'Competition is merely one consideration here' Striking the balance is for the Commission, and we cannot say it did so improperly." 78/

77/ (Footnote continued)

deemed essential. Such rules may have an anticompetitive effect in that not all persons will be able to comply because of lack of adequate financing or other reasons. Nonetheless, in weighing its responsibilities, the Commission has determined that the objectives, policies and purposes of the Act can be met, in its judgment, only by regulations such as these."

41 Fed. Reg. 51808, 51809 (November 24, 1976) at App _____.

78/ The Supreme Court has repeatedly recognized that repeal of the antitrust laws will be implied to the extent necessary to permit an agency to implement the provisions of a conflicting regulatory scheme. See Gordon v. New York Stock Exchange, 422 U.S. 659 (1975); United States v. National Association of Securities Dealers, 422 U.S. 694 (1975); Silver v. New York Stock Exchange, 373 U.S. 341, 357 (1963); United States v. Interstate Commerce Commission, (Northern Lines Merger Cases), 396 U.S. 491, 511-515 (1970), citing Country of Marin v. United States, 356 U.S. 412, 416-418 (1958); Pan American World Airways, Inc. v. United States, 371 U.S. 296, 301, 309-310 (1963).

Thus, the district court properly held that the Commission had adequately considered the anticompetitive factors cited by plaintiffs and properly refused to substitute its judgment for that of the Commission.^{79/}

C. The Court Below Correctly Held That
the Commission's Other Regulations Were
Not Arbitrary and Capricious.

Plaintiffs have challenged the registration, minimum financial,^{80/} disclosure and segregation provisions of the Commission's regulations as being arbitrary, capricious and discriminatory.

Disclosure Requirement

As we have seen (supra pp. 16-32), the record of the rulemaking proceeding, the legislative history of the Act, and the Commission's enforcement experience all demonstrate that a significant number of commodity options have been and are being sold through the use of high-pressure sales tactics to persons unfamiliar with the commodity markets generally, and with commodity options in particular. Even when disclosure has been made to option customers, it has often been inaccurate or misleading, either in content, presentation, or both. For these reasons Section 32.5 of the Commission's option regulations

^{79/} Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402 (1971).

Although the district court expressly held that "[p]laintiffs have shown us no reason to challenge the Commission's statement that it did consider the anticompetitive impact of various alternatives," plaintiffs now shift their emphasis and complain that the court below did not explicitly state that the Commission had also "endeavored" to take the least anticompetitive means to effectuate the purposes and policies of the Act. (B. Br. 42; N. Br. 21). But the court below, in emphasizing the very statutory language upon which plaintiffs now rely, plainly recognized and applied the correct standard.

^{80/} The segregation provision (Section 32.6) has fully been discussed supra in Part I of the Argument.

require that a summary disclosure statement must be furnished by a futures commission merchant to a commodity option customer in advance of any option transaction so that the customer can become familiar with certain aspects of commodity option transactions. The required disclosure document must set forth a brief description of the commodity option transaction being offered, the type of costs that may be incurred, certain elements of risk, and certain specified statements relating generally to commodity option transactions. In addition, upon execution of a commodity option transaction, the customer must receive a confirmation statement including particularized price information.^{81/}

Plaintiffs suggest (B. Br. 46-47) that certain of the required disclosures are "slanted and improper," are directed solely at the option industry, and will place option firms at a competitive disadvantage when compared with the sellers of futures contracts and stock options offered on the Chicago Board Options Exchange. But futures contracts are standardized and each and every one of their provisions must be approved by the Commission. Moreover, they are offered in a pervasively regulated marketplace the professional participants in which are each individually subject to Commission regulation. Similarly, stock

^{81/} The Commission had originally proposed that a more particularized disclosure statement be provided to customers not less than 24 hours prior to the entry into each commodity option transaction. Commentators persuasively argued, however, that the 24 hour period was impractical because of the volatile nature of the commodities markets, and that delivery of a disclosure statement prior to each transaction was unduly burdensome. Commentators also reasonably suggested that the summary disclosure statement might be limited to generalized transaction information with particularized data furnished as part of the confirmation statement. The Commission modified its proposed regulations to meet these constructive suggestions (SA1).

options traded on the CBOE have a standardized form and are the subject of pervasive regulation by the Securities and Exchange Commission. Significantly, they relate only to underlying securities which have been publicly offered in compliance with the broad disclosure requirements of the securities laws, and the issuers of which must comply with periodic reporting requirements those laws contain. In these circumstances, additional disclosure requirements would be redundant, and it is preposterous for plaintiffs to have suggested that the unregulated sale of commodity options is in any way comparable or to have claimed that the minimal disclosure requirements the Commission has imposed could for that reason be viewed as unfairly burdensome or discriminatory.

Moreover, plaintiffs' assertions (B. Br. 46, 48) that the disclosure requirements have had and will have a "material and adverse" effect upon their activity is unsupported by any evidence of record.^{82/} On the other hand, if, as plaintiffs state, the public has evidenced an increasing unwillingness to deal with them since they have been required to disclose material facts to their customers--which seems a fair inference from the assertions they make (B. Br. 46)--this is hardly a basis upon which the disclosure requirements may or should be found objectionable. It is the purpose of the requirements to permit customers to make an informed judgment.

^{82/} Plaintiffs point (B. Br. 46) to an income statement--uncertified and unverified--which reflects less gross sales income for December, 1976 than that for the month of November, 1976. But they have adduced no evidence to link the reduced sales to any of the regulations here involved.

Minimum Financial Requirement

The interim option rules adopted by the Commission include amendments to Commission Regulation 1.17. Under that regulation futures commission merchants must maintain a minimum adjusted working capital in excess of either (1) a fixed dollar amount specified therein or (2) a "safety factor" computation based upon a percentage of the market value of open futures contract positions,^{83/} if any, plus 5% of the firm's aggregate indebtedness^{84/} whichever is greater. For futures commission merchants engaged in options activity the fixed dollar amount is \$50,000 (§1.17(b)(1), SA7), while the amount for futures commission merchants dealing exclusively in futures contracts is \$10,000 (see §1.17(a), 17 C.F.R. 1.17(a) (1976) (SA51)).

Because persons dealing in options must comply with higher net capital requirements, plaintiffs would have this Court set aside §1.17 as "discriminatory" (B. Br. 41-42). But the imposition of a stricter standard on one group of persons does not invalidate the provision, where, as here, it is predicated on rational distinctions concerning the safeguards available, which make the customers of futures commission merchants involved solely in futures activity less subject to the risk of loss from any default by the firm with which they deal. Thus, in contrast to the options area, a futures commission merchant dealing

^{83/} The utilized percentage of the market value of open futures contract positions is referred to in the rule as a "safety factor." See Sections 1.17(d), (e), 17 C.F.R. §1.17(d), (e) (1976) (SA 53-54).

^{84/} Aggregate indebtedness is basically that portion of the total liabilities (with certain exceptions) which are not adequately collateralized, that is, not secured by identified assets pursuant to a written instrument. See Section 1.17(c)(7), 17 C.F.R. §1.17(c)(7) (1976) (SA53).

exclusively in futures contracts must not only segregate customer funds but must also, on a daily basis, mark unrealized gains and losses on open futures contracts to the market and deposit funds to cover any net unrealized losses. These entities are further monitored by industry self-regulatory organizations which are in a position to provide early warning of financial instability of a firm.

Plaintiffs also persist (B. Br. 44) in an apparently deliberate misinterpretation of §1.17 (SA51), asserting that the net capital requirements are designed to put option firms out of business; they claim that under the alternate computations in §1.17, they will be forced to "exclude all income for the next six to eighteen months while they are charged with expenses." If segregation were in effect, however, the plaintiffs could include segregated funds in their computations to meet the net capital requirements (JA608-609); and their reference to taking a "5% haircut on customers' equity" (B. Br. 44) demonstrates a material misstatement of the proper treatment of unrealized gains on options under §1.17, as plaintiffs' counsel well knows. The Commission made clear to the district court and to all option firms since December 3, 1976, that if an option dealer is acting in an agency capacity in the purchase of options for its customers' accounts, any unrealized gains on open options contracts will not be treated as a "receivable" from the London broker or as a "payable" to customers for the purpose of the net capital computation, regardless of how such assets and liabilities are treated for accounting purposes (JA608). Therefore, a "receivable" would not be subject to a 5% charge ("haircut") against the dealer's current assets and would also not be included in its aggregate

indebtedness. Although plaintiffs assert that the confusion over the net capital provision has created "chaos in the industry" (B. Br. 45), it is a matter of public record that 54 option firms have been registered as futures commission merchants by the Commission within the past 10 weeks (see n. 86, infra and accompanying text); so far as we are aware, not a single application has been delayed by reason of any uncertainty concerning these matters.^{85/}

In any event, this Court has found it appropriate to rely upon the interpretive views of an agency as expressed by its counsel, recognizing that "[t]he interpretation of a regulation or statute by a regulatory agency that is charged with administering it is given considerable deference by federal courts . . . so long as it is not clearly unnatural or unreasonable." Perine v. William Norton & Co., Inc., 509 F. 2d 114, 120 (2d Cir. 1974).

Registration Requirement

Plaintiffs assert that the registration provision is unlawful because, they say (B. Br. 35), the Commission may arbitrarily delay completion of the registration process as to any given firm. Plaintiffs

^{85/} Plaintiffs suggestion that Commission employees are giving varying interpretative views is unsupported and contrary to the facts (JA607-609). The letter referred to by plaintiffs (B. Br. 45) was issued on Dec. 1, 1976, shortly after adoption of the rules and before the Commission position had been formulated. The letter is not typical and, in any event, the views of a subordinate employee are not to be relied upon by the courts as necessary reflecting the views of an agency. Kixmiller v. Securities and Exchange Commission, 492 F. 2d 641 (D.C. Cir. 1974); International Paper Co. v. Federal Power Commission, 438 F. 2d 1349 (2d Cir. 1971); National Automatic Laundry & Cleaning Council v. Shultz, 443 F. 2d 689 (D.C. Cir. 1971).

rely upon a Wall Street Journal article (which is not in the record and not entitled to be) to the effect that registration may take up to six months. They assert, with no evidence of any administrative impropriety whatsoever, that fifteen firms have been required to "cease doing business" as a result of implementation of the registration requirements on January 17 (JA684).

But the Commission has stated that the registration process will normally take from thirty to sixty days--not six months--as counsel for plaintiffs is well aware (SA3); only where some question has been raised concerning financial responsibility or fitness for registration will the processing of a completed application take longer. Moreover, on January 17 the Commission was able publicly to announce that 49 firms had by then been registered as futures commission merchants expressly for the purpose of offering options to the public under the regulations the Commission has adopted.^{86/}

Another fifteen firms (to which plaintiffs refer) had applied for registration before that date but had not been registered. The reasons varied. For example, some had been tardy in applying, others had failed to file their registration applications in proper form, still others had not shown that they had adequate working capital. As a result, those fifteen firms could not lawfully sell commodity options after the effective date of the registration requirements.

^{86/} Five additional firms have since been registered to trade commodity options. Many of the 287 other firms that have heretofore registered with the Commission as futures commission merchants are undoubtedly eligible to offer options if they should wish to do so. However, they are not required by law to make their intentions known.

Three of the fifteen firms that have not been registered--including plaintiffs British American Commodity Options Corp. and First New York Commodity Options Limited--have been formally charged with fraudulent or deceptive practices in the sale of commodity options. These allegations have been set forth in complaints instituting administrative proceedings.^{87/} As provided in Section 8a(2) of the Commodity Exchange Act, as amended, hearings will be held to determine whether the allegations of fraud and deception are true, whether the respondents are for that reason unfit to be registered, and, if so, whether the Commission should refuse registration to those firms. As Section 8a(2) further provides, "pending final determination" of the proceedings, "registration shall not be granted"

Of course, even if there were merit to plaintiffs' claim (B. Br. 35) that the registration requirements are susceptible to arbitrary application, only the validity of the rules themselves, and not their application, was placed in issue before the district court and is the subject of this appeal. Accordingly plaintiffs' contentions with respect to the registration process--as distinguished from the registration provisions--are irrelevant.^{88/}

^{87/} Matter of British American Commodity Options Corp., New York (CFTC No. 77-3); Matter of London Commodity House, Inc., Chicago (CFTC No. 77-4); First New York Commodity Options, Ltd., Englewood (CFTC No. 77-5).

^{88/} An applicant for registration is not without judicial recourse in the event of unfair treatment, as plaintiffs seem to suggest. The court may entertain a suit to compel "agency action unlawfully withheld or unreasonably delayed." See 5 U.S.C. §706(1) (1970).

And plaintiffs' claims are erroneous as well. The express provisions contained in Section 8a(2) of the Act prescribe detailed standards pursuant to which the Commission may "refuse to register any person" as, among other things, a futures commission merchant or a person associated therewith. Thus, plaintiffs' assertion (B. Br. 32) that the registration requirement is unlawful because no criteria for fitness exist is wholly baseless.^{89/} In fact, the efficacy of these standards as a basis upon which the Commission may properly refuse registration has recently been upheld by the United States Court of Appeals for the Seventh Circuit in Savage v. Commodity Futures Trading Commission, No. 76-1241 (January 17, 1977)--a case in which the Commission's refusal to register a convicted felon as a commodity trading advisor was emphatically affirmed.

Also baseless is plaintiffs' suggestion (B. Br. 32) that the existence of regulation 1.19, 17 C.F.R. §1.19 (1976), makes Section 32.3 contradictory, precluding plaintiffs from engaging in a commodity option business without violating its terms. Regulation 1.19 provides that no futures commission merchant shall "make, underwrite, issue, or otherwise assume any financial responsibility for the fulfillment" of commodity option transactions. It does not, however, prohibit futures commission merchants from accepting money from option customers in connection with option transactions if the futures commission merchant acts solely in an agency capacity, which, so far as the record shows, is

^{89/} In view of the standards of Section 8a(2) and for unambiguous application to the registration provisions for futures commission merchants and associated persons, it is irrelevant that the standards of Section 4n(7) of the Act do not apply to this situation (see B. Br. 34-35).

all that any of the plaintiffs intend to do.^{90/}

CONCLUSION

For the foregoing reasons the decision of the district court should be reversed insofar as it enjoined enforcement of the segregation requirement of Rule 32.6 and denied summary judgment to the Commission concerning the validity of that provision. In all other respects the decision of the court below should be affirmed.

Respectfully submitted,

RICHARD E. NATHAN
Acting General Counsel

FREDERIC T. SPINDEL
Associate General Counsel

VIRGINIA CRISMAN
Attorney

Commodity Futures Trading
Commission
2033 K Street, N.W.
Washington, D. C. 20581

February 3, 1977

^{90/} 41 Fed. Reg. 51813 (November 24, 1976) (SA6).

SUPPLEMENTAL APPENDIX

REGULATION AND FRAUD IN CONNECTION WITH COMMODITY AND COMMODITY OPTION TRANSACTIONS

General Regulations Under the Commodity Exchange Act, Adoption of Rules

The Commodity Futures Trading Commission ("Commission") has adopted interim regulations under the Commodity Exchange Act, as amended, 7 U.S.C. 1 et seq. (Supp. V, 1975), relating to commodity options substantially in the form previously announced with certain technical and substantive revisions deemed necessary as a result of comments received. On October 8, 1976, the Commission published a proposal to adopt interim regulations as the first step in a two-stage procedure under which the Commission plans to adopt comprehensive regulations for a limited, rigidly-controlled, three-year (or shorter) test program that ultimately will require commodity options to be purchased and sold on or through the facilities of Commission-designated boards of trade in the United States or Commission-recognized foreign options systems. See 41 FR 44560 (October 8, 1976). Except to the extent discussed below, the Commission's discussion of the basis and purpose of rules proposed at that time constitutes the basis and purpose of the interim rules adopted today. A copy of the Commission's announcement of October 8, 1976, is published as an appendix¹ to this FEDERAL REGISTER notice.

The Commission's October 8, 1976 FEDERAL REGISTER notice contained a review of the Commission's consideration of the issues surrounding the regulation of commodity options in this country, including a summary of the Commission's prior regulatory proposals; set forth a discussion of the basis and purpose of the Commission's two-stage regulatory proposal, including a section-by-section analysis of the Commission's proposed interim rules; and invited interested persons to participate in the rule-making process by providing written submissions to the Commission. The Commission has considered all of the comments and suggestions received and has determined to adopt the interim rules in the form set forth below. Such rules, as adopted, shall become effective 15 days after publication of this notice in the FEDERAL REGISTER (December 9, 1976), except that the segregation provisions contained in § 32.6 of the rules will become effective 30 days after such publication (December 27, 1976).

At the outset, the Commission wishes to emphasize certain aspects concerning the interim rules adopted today. The authority granted to the Commission by the Congress to regulate commodity option transactions is extremely broad. Under section 2(a)(1) of the Act, 7 U.S.C. 2

¹ Appendix is filed as part of original document.

RULES AND REGULATIONS

(Supp. V, 1975), the Commission has "exclusive jurisdiction" with respect to "accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option' . . .), and transactions involving contracts of sale of a commodity for future delivery . . ." Section 4c (a) (B) of the Act prohibits the offer and sale of certain commodity options—generally those relating to agricultural commodities which were regulated under the Commodity Exchange Act prior to the 1974 amendments thereto. For a list of those commodities see section 2(a) (1) of the Act and § 32.2(a) of the regulations adopted today. Under section 4c(b) of the Act, it is unlawful to offer or sell an option involving any other commodity regulated under the Act contrary to such rules and regulations as the Commission may prescribe.² In pertinent part, that section provides as follows:

No person shall offer to enter into, enter into, or confirm the execution of, any [commodity option] transaction . . . contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe. . . .

Accordingly, the Commission is empowered under section 4c(b) to determine if and under what circumstances commodity option trading will be permitted. Under this authority the Commission could prohibit all commodity option trading, permit all commodity option trading under such terms and conditions as it shall prescribe, or permit some forms of trading, subject to the Commission's rules and regulations, and prohibit others.

The rules announced today reflect the Commission's considered judgment as to the appropriate method of regulating commodity option transactions in this country. The Commission's determination has been made after extensive Commission study of the offer and sale of commodity options in the United States, a process which has consumed substantial Commission resources and has involved the solicitation of the broadest possible public participation. Just four days after the effective date of the Commodity Futures Trading Commission Act of 1974, which established the Commission, the Commission solicited written comments with respect to its proposed antifraud rule relating to commodity options. 40 FR 18187 (April 25, 1975). On June 24, 1975, the Commission adopted a broad antifraud rule applicable to commodity option transactions. 40 FR 26505 (June 24, 1975). On October 22, 1975, the Commission announced that it was con-

sidering the adoption of rules to regulate—or perhaps forbid—transactions in commodity options, including the promulgation of a temporary rule pending the adoption of a definitive regulatory program. 40 FR 49360 (October 22, 1975). On February 20, 1976, the Commission proposed comprehensive regulations governing off-exchange commodity option transactions. 41 FR 7774 (February 20, 1976). At the time of that proposal, the Commission stated that it was affirmatively considering restricting commodity option transactions solely to organized exchanges and the Commission invited public comment on whether the Commission's regulatory program should include the segregation of premiums received by option dealers and the delivery of a disclosure statement to prospective purchasers. The Commission received written comments following the publication of its proposal, and the Commission held oral hearings in Washington, D.C., on March 8, 1976, during and subsequent to which it received additional comments on the issues raised by its announcement.

During this period, the Commission's Advisory Committee on the Definition and Regulation of Market Instruments was also considering regulatory recommendations relating to commodity options. That Committee was requested to submit a report and recommendations to the Commission on appropriate regulations or restrictions concerning commodity options. See 40 FR 32866 (August 5, 1975). The Advisory Committee's report was transmitted to the Commission on July 6, 1976 and was published as a special supplement, numbered 26, to the CCH Commodity Futures Law Reporter (July 15, 1976) and was also made available by the Commission to all interested persons.

After carefully considering the comments received on its prior proposals, the presentations made at its oral hearing in March 1976, the report and recommendations of its Advisory Committee, and the comments received on its proposal of October 8, 1976, the Commission has determined to adopt the interim rules announced today pursuant to the broad authority contained in sections 2 (a) (1), 4c(a), 4c(b) and 8a(5) of the Act. The Commission believes that affected persons and members of the public have had ample opportunity to comment on the Commission's proposed regulatory program; the Commission has evaluated all of the comments received; and the Commission has determined that the public interest requires that it adopt rules regulating the offer and sale of the commodity options without further delay.

Many of the persons who commented on the Commission's proposal of October 8, 1976, maintained that the Commission's proposal was anti-competitive in various respects: that it imposed stricter standards on persons dealing in commodity options than are presently imposed on persons dealing in commodity futures contracts; that it discriminated unfairly between futures commission merchants dealing in commodity options and futures commission merchants deal-

ing in commodity futures contracts; and that it required disclosures to prospective option customers that are not required to be made to prospective customers dealing in commodity futures contracts. In proposing and in adopting the interim rules, the Commission has taken into account its responsibilities under section 15 of the Act, 7 U.S.C. 19 (Supp. V, 1975), and has determined that the options regulations in the form proposed and as adopted meet the requirements of that Section. Section 15 requires that the Commission take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives, policies and purposes of the Act. While the Commission is mindful that the financial, segregation and other criteria imposed as prerequisites to allowing a person to enter into or continue in the commodity options business may result in some lessening of competition, in its judgment, the interim rules are necessary to effectuate an essential purpose and policy of the Act: That is to require that the Commission provide essential customer protections which would attempt to assure the financial solvency of option transactions and prevent fraud. As a result, rules have been adopted, particularly in the areas of registration, disclosure, segregation and minimum working capital, which are intended to provide such customer protections as are deemed essential. Such rules may have an anticompetitive effect in that not all persons will be able to comply because of lack of adequate financing or other reasons. Nonetheless, in weighing its responsibilities, the Commission has determined that the objectives, policies and purposes of the Act can be met, in its judgment, only by regulations such as these.

In this connection the Commission wishes to emphasize that, since its inception in April 1975, a very substantial part of its resources devoted to the enforcement of the Act and the regulations thereunder have been directed to monitoring the activities of commodity options dealers, to investigating those activities, and to bringing resulting enforcement actions. The Commission believes that its experience of the past 18 months bears out the Congressional judgment that strong regulatory safeguards are needed in connection with the commodity options business [see, e.g., H.R. Rep. No. 93-975, 93d Cong., 2d Sess., 37 (1974)]. The Commission's experience in the field of futures contracts has been salutary in comparison to the options area. As a result, the Commission has provided for greater financial responsibility and increased disclosure requirements for option dealers than for those dealing with futures contracts.

The Commission does not understand section 15 of the Act to require that the Commission permit entry into or maintenance of the commodity options business at the expense of the public interest considerations with which the Act is concerned. On the contrary, the Commission views section 15 as a Congressional judgment that the public interest protected

² Section 4c(b) governs options involving the newly-regulated commodities (i.e., those coming under regulation after the 1974 amendments to the Commodity Exchange Act), namely "all other goods and articles [except onions] . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in . . ." Section 2(a) (1) of the Act.

³ In addition, the Commission has general rule-making authority under Section 8a(5) of the Act, 7 U.S.C. 12a(5) (Supp. V, 1975).

by the antitrust laws be considered in the context of the Commission's judgment of how best to effectuate the policies and purposes of the Act, including the Commission's express authority to regulate—or to forbid—commodity option transactions. Thus, the essential judgments made have been made in light of section 15 of the Act.

The Commission also wishes to stress that as proposed and as adopted, § 32.3 of the interim rules provides that on and after January 17, 1977, it will be unlawful for a person to solicit or accept orders for commodity options transactions or for an individual to be associated with any such person, unless registered as a futures commission merchant or as an associated person of such futures commission merchant, respectively, under the Act. Therefore, the Commission again wishes to advise affected persons to file their applications for registration promptly. The Commission is already processing applications for registration which it has received as a result of its announcement of the proposed interim rules. A person who defers filing an application runs the risk that the application may not be processed before the January 17th deadline. Normal requirements for processing are 30–60 days. While the Commission intends to expedite the processing of applications, a prompt filing will enable the Commission to do so on a timely basis.

Finally, the Commission stated in its October 8, 1976 announcement that the proposed interim rules would become effective on November 22, 1976. In order to alleviate some of the concerns expressed by the commentators that it would be difficult to comply with certain aspects of the proposed interim rules by that date, the Commission has determined to adopt the interim rules effective December 9, 1976, and, with respect to the segregation requirements contained in § 32.6, December 27, 1976. However, as indicated above, the Commission has determined to retain the January 17, 1977 date in the registration provisions of the interim rules.

Set forth below is a synopsis of the interim rules in the form adopted, together with the discussion of certain general and specific comments received by the Commission and of the revisions made in the proposed interim rule as a result of those comments and further consideration by the Commission.

DEFINITIONS

One commentator suggested that the definition of "option customer" in § 32.1 (c) should be amended to include a person who writes or grants an option through a futures commission merchant, since such a person is a customer of the futures commission merchant. The Commission has determined not to amend the definition at this time because it believes for purposes of its interim rules that coverage of option customers by virtue of the definition is sufficiently broad to encompass the vast majority of persons who are affected by such transactions. However, the Commission is considering appropriate amendments to the option customer definition in connection

with the second stage of its regulations to be announced shortly. It was also suggested that the definition of "purchase price" in § 32.1(d) was too broad and should be broken down into its essential components such as the premium, sales commissions and other fees. In light of the Commission's treatment of segregated funds, discussed below, where such definition has particular importance, the Commission does not believe that an amendment to this definition is desirable.

PROHIBITED TRANSACTIONS

One commentator suggested that § 32.2(b) should be amended to make clear that that section prohibits only the offer or sale of commodity options involving domestically traded futures contracts and prices of such contracts, and not commodity option transactions relating to futures contracts traded on foreign boards of trade. The Commission believes that § 32.2(b) is sufficiently clear on this point and does not purport to prohibit commodity option transactions involving futures contracts traded on foreign boards of trade. Of course, such transactions are prohibited if the contracts involve those commodities which were regulated prior to the 1974 amendments to the Act and which are the subject of section 4c(a)(B) of the Act, as incorporated in § 32.2(a) of the interim rule.

UNLAWFUL COMMODITY OPTION TRANSACTIONS

As proposed and as adopted, § 32.3 specifies the circumstances under which persons accepting funds or other property from option customers as payment of the purchase price of the commodity option or soliciting or accepting orders for commodity options are required to register as futures commission merchants or associated persons under the Act. One commentator suggested that § 32.3(a) be amended to make clear that the resale of a commodity option by an option customer to a writer does not require the customer to register as a futures commission merchant. The Commission does not interpret § 32.3 as requiring the registration of option customers because of the occasional resale by an option customer to a writer and, accordingly, does not believe that an amendment to this section is necessary.

It was also suggested that § 32.3(c) be amended to make clear that persons registered under the interim rules need not register as commodity trading advisors if their services are rendered on a basis solely incidental to their commodity option activities. This was the intent of § 32.3(c) and to make this clear, the Commission has incorporated such an amendment in § 32.3(c)(2) as adopted.

Another commentator suggested that the proposed rule be amended to provide that persons already registered as floor brokers under the Act need not register as associated persons in accordance with the terms of the interim rule. This suggestion is consistent with the provisions of section 4k(1) of the Act and therefore the Commission has amended § 32.3(d) and has added a new § 32.3(e) to provide that a person registered as an associated

person or a floor broker under the Act need not register as an associated person in order to comply with § 32.3. In addition, as proposed, § 32.3(d) provided that persons who need not register as associated persons under § 32.3 by virtue of their existing registrations under the Act were nevertheless required to notify the Commission immediately in writing, specifying the date such person commenced or intends to commence engaging in activities otherwise requiring registration under that section. As adopted, the Commission has deleted this requirement from § 32.3(d), and, in new § 32.3(e), has required the employing futures commission merchant to provide this notification to the Commission. The Commission believes that this change will reduce the number of reports which need to be filed by affected persons in order to comply with § 32.3.

One commentator suggested that the Commission's determination to make it unlawful for persons to accept money and other funds from option customers unless registered as futures commission merchants was, in effect, an amendment of the Act's definition of a futures commission merchant. The Commission disagrees. Persons who come within the definition of futures commission merchant in section 2(a)(1) of the Act are required to register as such thereunder. The Commission's adoption of the interim rules in no way alters that obligation and in no way alters the definition of futures commission merchant contained in the Act. Rather, as the Commission stated at the time of its October 8, 1976 proposal, the Commission has determined, pursuant to its plenary power to regulate commodity option transactions, to entrust options activities only to persons who meet the basic financial and other requirements of futures commission merchants and associated persons of specified futures commission merchants under the provisions of the Act and the regulations promulgated thereunder.

EXEMPTIONS

As proposed, § 32.4(a) provided that, except for the provisions of §§ 32.2 (prohibited transactions) and 32.9 (fraud in connection with commodity option transactions), the provisions of the interim rules do not apply to certain trade option transactions. However, as will be discussed more fully below, the Commission has adopted new §§ 32.8 (b) and (c) as explicit codifications of activity which the Commission considers presently to be violations of its anti-fraud rule. In addition, proposed § 32.8, adopted as § 32.8 (a), was believed to have limited applicability in a trade exemption situation since it dealt with unlawful representations as to registration. Nonetheless, since it also proscribes representations being made concerning the Commission's approval of the transaction, the Commission believes that § 32.8(a), as well as the newly adopted §§ 32.8 (b) and (c), should apply in trade exemption situations. Accordingly, the Commission has adopted the trade option transaction exemption in the form proposed, with the addition of the applicability of § 32.8 thereto.

DISCLOSURE

The Commission received many comments strongly critical of the disclosure provisions of the proposed interim rule contained in § 32.5. Commentators suggested that the requirement that an option customer receive the summary disclosure statement contemplated by § 32.5 (a) not less than 24 hours prior to the entry into the commodity option transaction was unrealistic in light of the volatile nature of the commodities markets. In addition, commentators noted that § 32.5(a), which could be interpreted to require delivery of a summary disclosure statement prior to the entry into each commodity option transaction, would be unduly burdensome. Furthermore, commentators pointed out that, as proposed, § 32.5 required summary disclosure of particularized price information if available, and if not available, disclosure of such information immediately upon execution of the commodity option transaction. Commentators suggested that a more practical approach would be to provide a generalized disclosure document regarding commodity option transactions prior to the entry into the commodity option transaction, with particularized data made available as part of the confirmation of the execution of the transaction. It was also suggested that the persons required to deliver the confirmatory price information be permitted to do so not later than one business day following execution of the transaction rather than "immediately".

The Commission believes that the foregoing comments are essentially constructive and has revised § 32.5 to incorporate these suggestions while retaining the basic thrust of the proposed disclosure rules. As adopted, § 32.5(a) eliminates the requirement that the summary disclosure statement be furnished not less than 24 hours prior to the entry into the commodity option transaction. However, the Commission wishes to emphasize that the option customer or prospective option customer must be furnished with the summary disclosure statement prior to the entry into a commodity option transaction. Accordingly, persons who intend to mail summary disclosure statements should obtain assurances that the summary disclosure statement has been received by the option customer or prospective option customer before entering into a commodity option transaction.

In addition, as adopted, § 32.5(a) eliminates the requirement that particularized price information be furnished as part of the summary disclosure statement. Rather, the summary disclosure statement shall contain (1) as a brief description of the commodity option transactions being offered, including (i) the duration of the commodity options being offered and the total quantity and quality of the commodities which may be purchased or sold upon exercise of the options being offered or which underlie the contracts of sale for future delivery which may be purchased or sold upon exercise of such commodity options; (ii) a listing of the elements comprising the purchase price to be charged, including the

premium, mark-ups on the premium, costs, fees and other charges, as well as the method by which the premium is established; (iii) the services to be provided for the separate elements comprising the purchase price; and (iv) the method by which the striking price is established; (2) a description of any and all costs in addition to the striking price which may be incurred by an option customer if the commodity option is exercised, including, but not limited to, the amount of storage, interest, commissions (whether denominated as sales commissions or otherwise), and all similar fees and charges which may be incurred; (3) a statement to the effect that the price of the commodity or contract of sale for future delivery underlying each commodity option transaction being offered must either rise above the striking price, or fall below the striking price, as the case may be, by an amount in excess of the sum of the premium and all other costs incurred in entering into and exercising the commodity option in order for the option customer to realize a profit on the commodity option transaction; and (4) a clear explanation of the effect of any foreign currency fluctuations with respect to options which are to be executed on or through the facilities of a foreign board of trade.

As adopted, § 32.5(a) retains the proposed provisions that the first page of the disclosure statement contain the boldfaced statement required by § 32.5 (a)(5). In addition, the summary disclosure statement must contain the statements called for by § 32.5(a)(6) to the effect that specific market movements of the commodities or contracts of sale of a commodity for future delivery underlying the options being offered cannot be accurately predicted and that, generally, an option customer will be unable to sell any option purchased in any market to recover any of the purchase price, but rather may only liquidate by exercising an option before the expiration of the option. The proposed requirement that a statement be made that an option customer may also liquidate by entering into an offsetting transaction has been deleted because, generally, no such offsetting trading mechanism exists at the present time.

As adopted, § 32.5(b) basically provides that the summary disclosure statement need not be provided to an existing option customer prior to entry into each option transaction except (1) upon request or (2) if the disclosure statement that has been previously provided to such customer has become outdated or inaccurate in any material respect. The Commission wishes to point out that § 32.5(b) applies only to existing option customers and that the summary disclosure statement must be provided to prospective option customers who have not previously entered into a commodity option transaction with the person required to provide the statement.

Moreover, although the summary disclosure statement need not contain particularized price data, the Commission believes that where information concerning particular price information is avail-

able prior to the entry into a commodity option transaction, option customers should be informed of such information. Accordingly, the Commission has adopted § 32.5(c), which specifies the price information which, if known prior to the entry into any commodity option transaction, must be disclosed to option customers and prospective option customers.

As adopted, § 32.5(d) of the interim rule relates to the required confirmation statement which must be delivered to all option customers after execution of each option transaction. That section basically provides that not more than 24 hours after the execution of a commodity option transaction, a commodity option customer must be furnished, by mail or other generally accepted means of communication, a written confirmation statement which contains at least (1) the actual amount of the purchase price, including a separate listing of the premium, markups on the premium, costs, fees and other charges; (2) the striking price; (3) the total quantity and quality of the commodity which may be purchased or sold or which underlies the contract of sale for future delivery which may be purchased or sold upon exercise of the commodity option; (4) the exercise date of the commodity option purchased and, in case of an option on a contract of sale for future delivery, the final trading date on such contract; and (5) the date the commodity option was executed.

The Commission believes that the foregoing changes in the disclosure requirements of § 32.5 will ameliorate many of the concerns expressed by the commentators. While the disclosure requirements have been adopted in a somewhat modified form, the Commission does not anticipate that affected persons should experience particular difficulty in complying with these revised provisions since substantially the same information will be required to be disclosed in this section as adopted as had originally been proposed. Some of the commentators objected to various aspects of the disclosure statement such as, for example, that the disclosure of markups was unwarranted, exceeded the Commission's authority and was not in accordance with normal commercial practice. The Commission's authority under § 4c(b), as previously indicated, is exceedingly broad and in light of the Commission's knowledge of markups in excess of 100% being charged in some cases, the Commission deems disclosure of such items to be an essential customer protection.

One commentator suggested that, as an alternative to its disclosure requirements, the Commission encourage development of an industry-wide brochure regarding commodity options. The Commission believes that this suggestion has some merit and encourages interested persons to work on such a brochure and to comment in this regard, particularly since standardized disclosure materials appear compatible with the Commission's proposed second-stage of regulations which will be designed to restrict commodity option trading on or through

the facilities of designated boards of trade in the United States and of recognized foreign options systems.

SEGREGATION

The strongest objections made to the Commission's proposed interim rules concerned the segregation requirements of § 32.6. The criticisms can be summarized as follows: (1) segregation of the entire purchase price is unfair since receipt of at least a substantial portion of the monies obtained from customers is necessary for the options dealer to be able to continue to conduct an options business and cover the payment of employees' salaries, sales commissions, administrative expenses, fees for executing brokers, and similar charges; (2) the inability of an options dealer to have available a portion of the purchase price for day-to-day operations would encourage options dealers to offer options of a shorter duration than are presently being offered, and force them to encourage their customers to exercise existing options prematurely in order to achieve a more favorable cash flow—both practices that could possibly be detrimental to option customers; (3) only larger firms with great amounts of capital could afford to stay in business if options dealers are required to comply with the Commission's proposed segregation requirements; and (4) futures commission merchants engaged in accepting margin from option customers trading commodity futures contracts are not required to segregate sales commissions, so that the Commission's proposal operated to discriminate unfairly against futures commission merchants engaged in options activities.

At the time of the announcement of its proposed interim rules, the Commission stated that it viewed the proposed segregation requirements as essential to protect at least the basic investment of commodity option customers as well as to assure, to the extent feasible, the financial integrity of option transactions. The Commission stressed that what is of paramount importance is that option customers be assured, at the very least, that the assets which they put up to purchase a commodity option will be safe during the term of the option, and be available to be refunded in the event that an option customer exercises the option but is unable to obtain satisfaction of the obligations owing to him because of the insolvency of his futures commission merchant or its principals. In its report to the Commission the Advisory Committee recognized and addressed this problem as follows:

At the present time, neither United States nor London vendors of ICCH or LME member options are required to segregate funds received from United States customers. Moreover, neither the ICCH nor the LME currently guarantees to United States customers the performance of obligations on any ICCH or LME option. The Advisory Committee has been informed that these and other circumstances, such as the absence of financial requirements for option dealers in the United States and the lack of regulation of the United States market for Foreign Options, make it very difficult for United States customers to obtain redress in the United

States from dealers of 'London' options in the event of a default on the option transaction. On this basis, the Advisory Committee has determined that, to the extent possible, these deficiencies should be remedied by the Commission." (CCH Commodity Futures Law Reporter, Special Supplement numbered 26 at pages 41-42 (July 15, 1976)).

The Commission firmly believes that by providing a minimum fund under segregation requirements, an essential customer protection, albeit a bare minimum one, will be afforded commodity option customers in the United States. Several commentators have indicated that letters of credit, bonding requirements, and other forms of financial guarantees could be used as alternatives to segregation. While the Commission believes that these suggestions are on the whole constructive, and while the Commission would urge continued efforts by commentators to suggest suitable alternatives to the segregation requirement, specific proposed alternatives have not yet been submitted which would be capable of being effectuated to coincide with the adoption of the interim rules. Accordingly, the Commission has determined to include segregation requirements in the interim rules as adopted, to provide for a minimal cash fund to be available in the United States for the benefit of option customers.

However, the Commission also realizes, as it stated at the time of its October 8, 1976 proposal, that the segregation requirements could result in so-called "double segregation", particularly with respect to the sale of London options and that affected persons will need time to take the necessary steps in order to be in compliance when the segregation requirements become effective. In addition, as the Commission also stated at that time, it had originally intended to permit futures commission merchants to exclude sales commissions from the assets required to be segregated. The Commission is persuaded by the comments it has received that it would not be inconsistent with customer protection considerations to permit futures commission merchants to withhold a portion of the purchase price received to help meet operating expenses or the costs of any necessary financing arrangements. Accordingly, as adopted, the Commission has amended § 32.6(a) to provide that up to a maximum of 10% of the money, securities or property accepted from an option customer as payment of the purchase price in connection with a commodity option transaction need not be treated and dealt with as belonging to the option customer and segregated as required by § 32.6. In addition, in order to provide additional time for affected persons to be in full compliance with the segregation requirements when they become effective, the Commission has determined to adopt § 32.6 effective December 30, 1976. Any affected person may, pursuant to § 32.4 (b), submit a written request to the Commission for exemption from the segregation requirements (or other requirements of these rules). However, any such request should be accompanied by complete and specific details of the basis

upon which the exemption is requested and of the alternative to segregation which the requesting person will utilize in connection with its commodity option transactions. The Commission points out that under the terms of § 32.4(b), an exemption will be granted only if the Commission finds, in its discretion, that it would not be contrary to the public interest to grant such exemption. The Commission will not, however, entertain frivolous or incomplete applications for exemption. Any bonding or letter of credit must contain a complete and unconditional obligation to the commodity option customer from an unquestionably financially sound entity before it will even be considered. The Commission has no intention of expending its limited resources on a myriad of exemption applications unless there is real substance to the proposed alternatives.

The Commission notes that one commentator suggested that a suitable alternative to segregation would be a form of commodity account insurance. On November 12, 1976, the Commission, as required by section 417 of the Commodity Futures Trading Commission Act of 1974, submitted to the Congress its report respecting the need for legislation insuring owners of commodity futures accounts and persons handling or clearing trades in such accounts against loss by reason of the insolvency or financial failure of a futures commission merchant carrying such accounts. In that report the Commission concluded that, at this time, the need for an insurance program is minimal because the level of public confidence in the safety of customer funds in the commodity futures industry is relatively high and that the benefit-cost ratios presented in the report demonstrate that such insurance protection would not be cost effective. In part, the Commission based its conclusion on the protection afforded by the Commission regulations requiring periodic audits of futures commission merchants and the segregation of customer funds, and the minimum capital requirements imposed on futures commission merchants. However, the Commission also indicated that it would reevaluate the concept of an insurance fund from time to time and, should circumstances warrant, will be prepared to make appropriate recommendations to the Congress. In this connection, the Commission would welcome comments with respect to whether an insurance program designed to protect the accounts of option customers would be an appropriate alternative to segregation and would be willing to review a sound proposal for an insurance program to achieve this end.

At the time the Commission originally proposed that segregation requirements be part of an interim rule it indicated that such requirements might have to be modified in the second-stage of its regulations to take into account option trading on boards of trade designated by the Commission and on recognized foreign options systems. In that connection, the Commission wishes to advise affected persons that the segregation requirements adopted by the interim rules reach

only the purchase price of the commodity option and do not purport to require segregation of equities accruing to the customer as a result of the commodity option transaction or of monies deposited by option customers which are not committed to a particular commodity option transaction. Accordingly, the Commission wishes to stress that the segregation requirements contained in the interim rules relate solely to the customer's basic investment in the commodity option and in no way are designed to guarantee performance of the fulfillment of the commodity option transaction to the option customer or to guarantee that there will be sufficient funds in segregation to cover accrued customer equities, or to provide that the option customer will receive the benefits of his bargain. The Commission considers it to be unlawful, and a violation of the Commission's antifraud rule governing commodity option transactions, 17 CFR 30.01, for any person to represent to its option customer that compliance with the Commission's interim rules guarantees fulfillment of a commodity option transaction. Accordingly the Commission deems it appropriate to codify its view in the interim rule and has adopted § 32.8(b) which explicitly makes such representations unlawful.

BOOKS AND RECORDKEEPING

The Commission has adopted § 32.7 concerning books and recordkeeping, substantially in the form proposed. However, commentators suggested that the Commission amend § 32.7(a) to require retention of solicitation material used on radio and television. This had been intended by the Commission's proposed requirement concerning the retention of all solicitation and advertising materials. However, the Commission has amended this section to make explicit the requirements that the text of standardized oral presentations and of radio, television, seminar or similar mass media presentations be retained. In addition, by virtue of the requirement in § 32.5(d), as adopted, that option customers receive confirmation statements, the Commission has included a requirement in § 32.7(a) that copies of such confirmation statements be retained.

It was also suggested that it was impractical to require in § 32.7(b) that persons keep a permanent record showing the true name of commodity option makers, underwriters, issuers or other persons who assume or purport to assume any financial responsibility for the fulfillment of any commodity option transaction, since the identity of such persons would often be unknown. Accordingly, the Commission has amended this section in the form adopted to require the retention of such information to the extent that such information is known or may be reasonably obtained by the person required to retain the information.

The Commission also received comments that the requirement in § 32.7(a), that persons retain and furnish to the

Commission upon request the true name and address of each prospective commodity option customer solicited, was unduly burdensome. The commentators believed that this requirement should be limited exclusively to option customers. The Commission disagrees. This provision imposes no greater burden than placing a check mark next to the name and address of the customer on the solicitation list utilized. Moreover, the Commission believes that this information, as well as its books and record-keeping requirements generally, will assist in the Commission's monitoring of the activities of persons offering commodity option transactions for compliance with the interim rules.

In view of the Commission's adoption of § 32.5(d), concerning the furnishing of commodity option customers with a confirmation statement, the Commission has deleted the last sentence of proposed § 32.7(d), as adopted, since the information called for by that sentence is to be furnished to the option customer as part of the confirmation statement.

The Commission has adopted § 32.8 of the proposed interim rules as § 32.8(a) without change. In addition, as indicated above, the Commission has adopted § 32.8(b) to make explicit the Commission's view that it is unlawful to represent that compliance with the provisions of the interim rule constitutes a guarantee of performance of the fulfillment of the commodity option transaction. Moreover, the Commission believes it to be a violation of its anti-fraud rule governing option transactions for any person, upon receipt of an order for a commodity option transaction, unreasonably to fail to secure prompt execution of such order. In order to make explicit this view, the Commission has adopted as § 32.8(c) a rule specifically proscribing such activity.

ANTIFRAUD

As proposed, the Commission has incorporated its antifraud rule governing commodity option transactions in § 32.9 of the interim rules. This provision has been included as part of the interim rules so that all rules affecting commodity options transactions will be in one place in the Code of Federal Regulations. Section 32.9 is the same rule that is presently in effect, 17 CFR 30.01, modified to incorporate certain of the definitions set forth in the interim rules and to delete certain unnecessary language. As the Commission indicated at the time of its proposal of the interim rules, the redesignation of § 30.01 as § 32.9 is technical only and will have no substantive effect on fraudulent activity prior to, on, or after the effective date of § 32.9. In this connection, the Commission wishes to stress that judicial interpretations of § 30.01 will, of course, continue to be applicable to new § 32.9. See *CFTC v. J. S. Love & Associates Options Ltd.*, CCH Com. Fut. L. Rep. ¶ 20,198 (S.D.N.Y., Aug., 12, 1976).

OPTION TRANSACTIONS ENTERED INTO PRIOR TO THE EFFECTIVE DATE OF THE INTERIM RULES

As proposed § 32.10 was intended to make clear that the interim rules are to have prospective effect only. However, to make clear that fraudulent activity occurring after the effective date of the interim rules in connection with a commodity option transaction lawfully entered into prior to their effective date is unlawful, the Commission has adopted § 32.10 to provide that nothing in the interim rules shall be construed to affect lawful activities that occurred prior to the effective date of the interim rules.

AMENDMENTS TO §§ 1.3 AND 1.17

The Commission has adopted these amendments in the same form as proposed on October 8, 1976. The amendment to § 1.3 of the Commission's regulations includes within the definition of "futures commission merchant" any person required to register as a futures commission merchant by virtue of the interim rules and the amendments to § 1.17 require that any futures commission merchant engaging in commodity option transactions referred to in Part 32 of the Commission's regulations would be required to have, and to maintain at all times, adjusted working capital equal to or in excess of whichever of the following is greater: (1) \$50,000 or (2) the sum of the safety factors described in § 1.17 with respect to both proprietary and customers' accounts plus 5% of the applicant's aggregate indebtedness. A futures commission merchant who is exempt from the financial requirements of § 1.17(a) would also be required to maintain minimum adjusted working capital of at least \$50,000, computed in accordance with the bylaws, rules, regulations or resolutions of the contract market which serve as the basis for such exemption. Based on its experience, as previously stated, the Commission believes that the distinction in working capital requirements between futures commission merchants who are engaging in options activity as opposed to those who are not, is necessary to provide a cushion against losses which are more likely to arise in the commodity options area. The Commission has also amended § 1.17 to add a new paragraph (c)(9) defining "customer" to include "option customer" as defined in the interim rules.

SECTION 1.19

It has been suggested that Commission regulation § 1.19, 17 CFR 1.19, precludes futures commission merchants from dealing in commodity options in accordance with the interim rules. The Commission disagrees. Section 1.19 precludes futures commission merchants from issuing or otherwise assuming financial responsibility for the fulfillment of commodity option transactions. It does not prohibit futures commission merchants from accepting money from option customers in connection with option transactions if the futures commission merchant acts solely in an agency capacity in a commodity option transaction. However, should futures commission merchants be obligated for the fulfillment of

the option upon exercise by the option customer, the futures commission merchant would be in violation of § 1.19. As previously stated, the Commission is considering the repeal of § 1.19 in connection with the proposed second stage of its regulations.

In consideration of the foregoing, the Commission, pursuant to its authority contained in sections 2(a)(1), 4c(a), 4c(b) and 8a of the Act, 7 U.S.C. 2, 6c(a), 6c(b) and 12a (Supp. V, 1975), hereby amends Chapter 1 of Title 17 of the Code of Federal Regulations by amending §§ 1.3(p) and 1.17, by deleting § 30.01 and by adding a new Part 32 as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. Section 1.3(p) is amended by adding a "(1)" after the word "means" and before the word "individuals", by deleting the period and adding the word "and" after the word "therefrom" and by adding the following:

§ 1.3 Definitions.

(p) . . .

(2) shall include any person required to register as a futures commission merchant under the Act by virtue of Part 32 of this chapter.

2. Section 1.17 is amended to revise paragraphs (a) and (b) and to add paragraph (c) (9) as follows:

§ 1.17 Minimum financial requirements.

(a) Except as provided in paragraphs (b) (1) and (b) (2) of this section, no person applying for registration as a futures commission merchant shall be so registered unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (1) \$10,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(b) (1) Except as provided in paragraph (b) (2) of this section, no person registered as a futures commission merchant shall engage in commodity option transactions referred to in Part 32 of this chapter unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (1) \$50,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each such person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(2) The requirements of paragraphs (a) and (b) (1) of this section shall not apply if the applicant for registration or registrant is a member of a contract market and conforms to minimum financial standards and related reporting re-

quirements set by such contract market in its bylaws, rules, regulations or resolutions approved by the Commission: *Provided, however,* That a futures commission merchant who engages in option transactions referred to in Part 32 of this chapter shall at all times maintain a minimum capital of \$50,000 computed in accordance with the applicable bylaws, rules, regulations or resolutions of such contract market which have been approved by the Commission.

(c) . . . (9) The term "customer" shall include an "option customer" as defined in Part 32 of this chapter.

PART 30—FRAUD IN CONNECTION WITH COMMODITY TRANSACTIONS

§ 30.01 [Removed]

1. Section 30.01 is removed.

PART 32—REGULATION OF COMMODITY OPTION TRANSACTIONS

2. Part 32 is added to read as follows:

Sec.	
32.1	Definitions.
32.2	Prohibited transactions.
32.3	Unlawful commodity option transactions.
32.4	Exemptions.
32.5	Disclosure.
32.6	Segregation.
32.7	Books and recordkeeping.
32.8	Unlawful representations; execution of orders.
32.9	Fraud in connection with commodity option transactions.
32.10	Option transactions entered into prior to the effective date of this Part.

AUTHORITY: Secs. 2(a)(1), 4c(a), 4c(b), 8a, Commodity Exchange Act (7 U.S.C. 2, 6c(a), 6c(b) and 12a (Supp. V, 1975)).

§ 32.1 Definitions.

As used in this Part—

(a) "Commodity option transaction" and "commodity option" each means a transaction or agreement in interstate commerce which is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty" involving any commodity regulated under the Act other than wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice;

(b) "Interstate commerce" shall be construed and have the same meaning as set forth in sections 2(a) and 2(b) of the Act;

(c) "Option customer" means any person who, directly or indirectly, purchases or otherwise acquires for value any interest in a commodity option, but shall not include a person required to register as a futures commission merchant in accordance with this Part;

(d) "Purchase price" means the total actual cost paid to be paid, directly or indirectly, by an option customer for entering into and maintaining an interest in a commodity option transaction, by whatever named called; and

(e) "Striking price" means the price at which an option customer may purchase or sell the commodity or the contract of sale of a commodity for future delivery which is the subject of a commodity option transaction.

§ 32.2 Prohibited transactions.

No person may offer to enter into, enter into, confirm the execution of, or maintain a position in, any transaction in interstate commerce involving:

(a) Wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice, or

(b) any contract of sale of any commodity for future delivery traded on or subject to the rules of any contract market or involving the prices of such contracts, except under such terms and conditions as the Commission shall prescribe;

if the transaction is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty".

§ 32.3 Unlawful commodity option transactions.

(a) On and after January 17, 1977, it shall be unlawful for any person to accept any money, securities, or property (or to extend credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction unless such person is registered as a futures commission merchant under the Act and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked.

(b) On and after January 17, 1977, it shall be unlawful for:

(1) Any person to solicit or accept orders (other than in a clerical capacity) for the purchase or sale of any commodity option, or to supervise any person or persons so engaged, unless such person is:

(i) Registered as a futures commission merchant under the Act, or

(ii) If such person is an individual, registered as an associated person of a specified futures commission merchant under the Act;

and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked; and

(2) Any futures commission merchant to permit an individual to become or remain associated with such futures commission merchant as a partner, officer or employee (or in any similar status or position involving similar functions) in

any capacity involving such solicitation, acceptance or supervision if such futures commission merchant knew or should have known that such individual was not registered as an associated person or that such registration has expired, been suspended (and the period of suspension has not expired) or revoked;

(c) A person required to register as a futures commission merchant or as an associated person in accordance with this section which furnishes the services specified in that portion of section 2(a) (1) of the Act defining the term "commodity trading advisor" shall not be included in the term commodity trading advisor if:

(1) At the time such services are furnished, such person is registered as a futures commission merchant, as a floor broker or as an associated person under the Act, and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked; and

(2) The furnishing of such services is solely incidental to the conduct of such person's activities relating to commodity option transactions.

(d) A person registered as a futures commission merchant under the Act, who is required to register as such by virtue of this section, need not register as such in order to comply with this section, but shall immediately notify the Commission in writing, specifying the date such person commenced or intends to commence engaging in activities otherwise requiring registration under this section.

(e) A person registered as an associated person or as a floor broker under the Act, who is required to register as an associated person by virtue of this section, need not register as such in order to comply with this section, but the futures commission merchant employing such person shall immediately notify the Commission in writing, specifying the date such person commenced or intends to commence engaging in activities otherwise requiring registration under this section.

§ 32.4 Exemptions.

(a) Except for the provisions of §§ 32.2, 32.8 and 32.9, which shall in any event apply to all commodity option transactions, the provisions of this Part shall not apply to a commodity option offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and that such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such.

(b) The Commission may, by order, upon written request or upon its own motion, exempt any other person, either unconditionally or on a temporary or other conditional basis, from any provisions of this Part, other than §§ 32.2, 32.8 and 32.9, if it finds, in its discretion, that it would not be contrary to the public interest to grant such exemption.

§ 32.5 Disclosure.

(a) Except as provided in paragraph (b) of this section, prior to the entry into a commodity option transaction, each option customer or prospective option customer shall be furnished a summary disclosure statement by the person soliciting or accepting the order therefor. The disclosure statement shall contain the following:

(1) A brief description of the commodity option transactions being offered including:

(i) The duration of the commodity options being offered and the total quantity and quality of the commodities which may be purchased or sold upon exercise of the options being offered or which underlie the contracts of sale for future delivery which may be purchased or sold upon exercise of such commodity options;

(ii) A listing of the elements comprising the purchase price to be charged, including the premium, mark-ups on the premium, costs, fees and other charges, as well as the method by which the premium is established;

(iii) The services to be provided for the separate elements comprising the purchase price; and

(iv) The method by which the striking price is established;

(2) A description of any and all costs in addition to the purchase price which may be incurred by an option customer if the commodity option is exercised, including but not limited to, the amount of storage, interest, commissions (whether denominated as sales commissions or otherwise), and all similar fees and charges which may be incurred;

(3) A statement to the effect that the price of the commodity or contract of sale for future delivery underlying each option transaction being offered must either rise above the striking price, or fall below the striking price, as the case may be, by an amount in excess of the sum of the premium and all other costs incurred in entering into and exercising the commodity option in order for the option customer to realize a profit on the commodity option transaction;

(4) A clear explanation of the effect of any foreign currency fluctuations with respect to commodity option transactions which are to be executed on or through the facilities of a foreign board of trade;

(5) The following boldfaced statements on the first page of the summary disclosure statement:

BECAUSE OF THE VOLATILE NATURE OF THE COMMODITIES MARKETS, THE PURCHASE OF COMMODITY OPTIONS IS NOT SUITABLE FOR MANY MEMBERS OF THE PUBLIC. A PERSON SHOULD NOT PURCHASE A COMMODITY OPTION UNLESS HE IS PREPARED TO SUSTAIN A TOTAL LOSS OF THE PURCHASE PRICE OF THE COMMODITY OPTION. SUCH TRANSACTIONS SHOULD BE ENTERED INTO ONLY BY PERSONS WHO ARE AWARE OF THE POTENTIAL FOR LOSS AND WHO UNDERSTAND THE NATURE AND EXTENT OF THEIR RIGHTS AND OBLIGATIONS.

THESE COMMODITY OPTIONS HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE COMMODITY FUTURES TRADING COMMISSION NOR HAS THE COMMISSION

PASSED UPON THE ACCURACY OR ADEQUACY OF THIS STATEMENT. ANY REPRESENTATION TO THE CONTRARY IS A VIOLATION OF THE COMMODITY EXCHANGE ACT AND THE REGULATIONS THEREUNDER;

(6) Statements to the effect that:

(i) Specific market movements of the commodities or contracts of sale for future delivery underlying the options being offered cannot be accurately predicted, and

(ii) Generally, an option customer will be unable to sell any option purchased in any market to recover any of the purchase price, but rather may only liquidate by exercising an option before the expiration date of the option.

(b) A person shall not be required to deliver the summary disclosure statement to an option customer as required by paragraph (a) of this section if a summary disclosure statement has previously been furnished by such person to the option customer: *Provided, however*, That notwithstanding the foregoing, a disclosure statement shall be delivered in any event (1) upon the request of the option customer, or (2) if the previously delivered disclosure statement has become outdated or has become inaccurate in any material respect.

(c) Prior to the entry into a commodity option transaction, each option customer or prospective option customer shall, to the extent the following amounts are known, be informed by the person soliciting or accepting the order therefor of the actual amount of the premium, markups on the premium, costs, fees and other charges comprising the purchase price, as well as the striking price and all costs to be incurred by the option customer if the commodity option is exercised.

(d) Not more than 24 hours after the execution of a commodity option transaction, each person which accepts any money, securities or property (or extends credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction shall furnish, by mail or other generally accepted means of communication, such option customer with a written confirmation statement containing at least the following information:

(1) The actual amount of the purchase price including a separate listing of the premium, mark-ups on the premium, costs, fees, and other charges;

(2) The striking price;

(3) The total quantity and quality of the commodity which may be purchased or sold, or which underlies the contract of sale for future delivery which may be purchased or sold, upon exercise of the commodity option;

(4) The exercise date of the commodity option purchased, and in the case of an option on a contract of sale for future delivery, the final trading date on such contract; and

(5) The date the commodity option was executed.

§ 32.6 Segregation.

(a) Any person which accepts money, securities or property from an option

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customer as payment of the purchase price in connection with a commodity option transaction shall treat and deal with such money, securities and property as belonging to such option customer until expiration of the term of the option or, if the option customer exercises the option, until all rights of the option customer under the commodity option have been fulfilled. Such money, securities, and property (1) shall be separately accounted for and segregated as belonging to such option customer, (2) shall be kept in the United States, and (3) shall not be commingled with the money, securities or property of any other person, including the money, securities or property received by a futures commission merchant to margin, guarantee or secure the trades or contracts of commodity customers (as defined in § 1.3(k) of this chapter) or with the money accruing to such commodity customers as the result of such trades or contracts: *Provided, however*, That the money, securities or property treated as belonging to an option customer may for convenience be commingled with the money, securities or property treated as belonging to any other option customer and deposited in the same account or accounts with any bank or trust company in the United States. Such money, securities and property, when so deposited with any bank or trust company, shall be deposited under an account name which will clearly show that it contains money, securities or property, segregated as required by this Part. Each person depositing such money, securities or property shall obtain and retain in its files for the period provided in § 1.31 of this chapter an acknowledgment from such bank or trust company that it was informed that the money, securities and property therein are being treated as belonging to option customers and are being held in accordance with the provisions of this Part. Such bank or trust company shall allow inspection of such accounts at any reasonable time by representatives of the Commission: *Provided, further*, That, up to a maximum of 10 percent of the money, securities or property accepted from an option customer as payment of the purchase price in connection with a commodity option transaction need not be treated and dealt with as belonging to the option customer and segregated as aforesaid.

(b) No money, securities or property deposited in accordance with paragraph (a) of this section shall be held, disposed of, used or treated as belonging to the depositing person or any person other than the option customers of such person: *Provided, however*, That such money may be invested in obligations of the United States, and in obligations fully guaranteed as to principal and interest by the United States. Such investments shall be made through an account or accounts used for the deposit of money, securities or property received from option customers and proceeds from any sale of such obligations shall be re-

deposited in such account or accounts. Each person which invests money belonging to option customers in obligations as described in this paragraph (b), shall separately account for such obligations and segregate such obligations as belonging to such option customers. Such obligations may only be deposited with a bank or trust company in the United States and shall be deposited under an account name which will clearly show that it contains obligations treated as belonging to option customers, segregated as required by this Part. Each person depositing such obligations shall obtain and retain in its files an acknowledgment from such bank or trust company that it was informed that the obligations are treated as belonging to option customers and are being held in accordance with the provisions of this Part. Such acknowledgment shall be retained for the period provided in § 1.31 of this chapter. Such bank or trust company shall allow inspection of the obligations at any reasonable time by representatives of the Commission.

(c) Each person which invests money treated as belonging to option customers as permitted hereunder shall keep a record showing the following: (1) The date on which such investments were made, (2) The name of the person through which such investments were made, (3) The amount of money so invested, (4) A description of the obligations in which such investments were made, (5) The identity of the depositories or other places where such obligations are segregated, (6) The date on which such investments were liquidated or otherwise disposed of and the amount of money received on such disposition, if any, and (7) The name of the person to or through which such investments were disposed of.

(d) Persons which invest money in obligations described in paragraph (b) of this section shall include such obligations in segregated accounts at values which at no time shall be greater than current market value, determined as of the close of the market on the last preceding market day.

(e) The deposit and/or investment of money as provided in paragraphs (a) or (b) of this section shall not operate to prevent the person so depositing and/or investing such money from receiving and retaining as its own any increment or interest resulting therefrom.

(f) The amount of money, securities and property which is and which must be in a segregated account in order to comply with the requirements of this Part shall be computed by each person required to segregate such money, securities and property as of the close of each business day. A record of such computation shall be made and kept, together with all supporting data in accordance with the provisions of § 1.31 of this chapter. Such computation shall be made prior to the opening of business on the next business day.

§ 32.7 Books and record keeping.

(a) Each person which accepts any money, securities or property (or extends

credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction shall keep full, complete and systematic records together with all pertinent data and memoranda of or relating to such transactions. Such records shall at least include all orders (filled, unfilled or cancelled), signature cards, books of records, journals, ledgers, cancelled checks, copies of all statements of purchase, exercise or lapse, and reports, letters, disclosure statements and confirmation statements required by § 32.5 of this Part, solicitation or advertising material (including the texts of standardized oral presentations and of radio, television, seminar or similar mass media presentations), circulars, memoranda, publications, writings, and all other literature or written advice distributed to option customers or prospective option customers. Upon the request of an authorized representative of the Commission, such person shall furnish the true name and address of each commodity option customer or prospective commodity option customer solicited.

(b) Each person referred to in paragraph (a) of this section shall also keep a record in permanent form which shall show the true name and address of each maker, underwriter, issuer or other person who assumes or purports to assume any financial responsibility for the fulfillment of any commodity option transaction solicited or accepted by such person, to the extent that such information is known or may be reasonably obtained by such person.

(c) Each person which accepts an order for a commodity option transaction from a person other than an option customer, shall keep full, complete and systematic records together with all pertinent data and memoranda of or relating to the transaction. Such records shall at least include the items set forth in paragraph (b) of this section and, to the extent necessary to reflect such person's participation in the transaction shall include all items set forth in paragraph (a) of this section.

(d) Each person which accepts an order for a commodity option shall immediately upon receipt thereof prepare a written record of such order, including an account identification and order number, and shall record thereon by time-stamp or other device, the date and time, to the nearest minute, that (1) the order is accepted, (2) the order is transmitted for execution, and (3) the order is executed.

(e) All records, memoranda and other documents required to be maintained by paragraphs (a) through (c), and to be prepared by paragraph (d), of this section shall be retained for the period specified in § 1.31 of this chapter, and each person required to maintain such records shall be required to produce the same for inspection and furnish true and correct copies thereof and information and reports as to the contents or meaning thereof when and as requested by any authorized representative of the Commission or the United States Department of Justice.

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§ 32.8 Unlawful representations; execution of orders.

It shall be unlawful for—

(a) Any person required to be registered with the Commission in accordance with this Part expressly or impliedly to represent that the Commission, by declaring effective the registration of such person or otherwise, has directly or indirectly approved such person, or any commodity option transaction solicited or accepted by such person;

(b) Any person in or in connection with an offer to enter into, the entry into, or the confirmation of the execution of, any commodity option transaction expressly or impliedly to represent that compliance with the provisions of this Part constitutes a guarantee of the fulfillment of the commodity option transaction;

(c) Any person, upon receipt of an order for a commodity option transaction, unreasonably to fail to secure prompt execution of such order.

§ 32.9 Fraud in connection with commodity option transactions.

It shall be unlawful for any person directly or indirectly—

(a) To cheat or defraud or attempt to cheat or defraud any other person;

(b) To make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof;

(c) To deceive or attempt to deceive any other person by any means whatsoever;

in or in connection with an offer to enter into, the entry into, or the confirmation of the execution of, any commodity option transaction.

§ 32.10 Option transactions entered into prior to the effective date of this part.

Nothing contained in this part shall be construed to affect any lawful activities that occurred prior to the effective date of this part.

The foregoing adoption by the Commission of the amendments to §§ 1.3 and 1.17, of the deletion of § 30.01, and of Part 32 shall become effective 15 days after the date this Notice is published in the FEDERAL REGISTER (December 9, 1976), except that § 32.6 of Part 32 of the foregoing rules shall become effective 30 days after the date of publication (December 27, 1976). In order to assure full and fair consideration of the various proposals that have been made over the many months in which option regula-

tions have been considered, it has not been possible to implement appropriate regulations before now. That consideration having now been completed, however, the Commission finds that the public interest requires that the foregoing rules be adopted without any further delay inasmuch as the public has been without the protection of a comprehensive regulatory program in an area which historically has been fraught with abuses. Moreover, there has been ample notice and public participation in this rule-making proceeding and affected persons have had adequate notice and opportunity to comment on the subject of these rules and the issues involved in their consideration, as well as the terms of the rules themselves substantially as adopted. Furthermore, affected persons have had an adequate opportunity, through prior notices, to take the necessary steps to be in full compliance with the rules by the effective dates thereof.

Issued in Washington, D.C. on November 22, 1976.

By the Commission.

WILLIAM T. BAGLEY,
Chairman, *Commodity Futures*
Trading Commission.

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GPO 908-145

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Title 17—Commodity and Securities
ExchangesCHAPTER I—COMMODITY FUTURES
TRADING COMMISSION
COMMODITY OPTIONS

Interim Rules

The Commodity Futures Trading Commission ("Commission") is considering adopting regulations under the Commodity Exchange Act, as amended ("Act"), 7 U.S.C. 1 et seq., relating to commodity options. The regulations are to be adopted in two stages. The first stage involves adoption of the interim regulations that accompany this notice as a new Part 32 of the Commission's regulations. The interim regulations are to become effective November 22, 1976, and will remain in effect thereafter, except to the extent amended by the second stage of the regulations. However, as indicated below, the Commission encourages comments on the proposed interim regulations in order to determine whether they should be modified prior to their adoption. The Commission anticipates the second stage of regulations will become effective in approximately 90 days.¹

Under the two-stage procedure, the Commission plans to adopt comprehensive regulations for a limited, rigidly-controlled three-year (or shorter) test program that ultimately will require commodity options to be purchased and sold on or through the facilities of Commission-designated boards of trade in the United States or Commission-recognized foreign commodities exchange systems which satisfy stringent self-regulation requirements. The test program will be designed to determine the nature and extent of the impact of commodity option trading on the underlying futures and cash markets, the economic utility of commodity option trading and the capability of the exchanges to conduct adequate market surveillance and to assure orderly markets. The Commission believes that the test program will enable the Commission to obtain sufficient data on which to base a permanent regulatory program concerning commodity options or, if necessary, to determine to prohibit trading in commodity options in the United States. The details of the test program will be provided at the time that the second stage of the regulations is proposed.

The principal authority of the Commission to regulate commodity option transactions is contained in Section 4c of the Act.² Section 4c(a)(B) of the Act

prohibits the offer and sale of certain commodity options—generally those relating to agricultural commodities.³ Under Section 4c(b) of the Act, however, it is unlawful to offer or sell an option involving any other commodity regulated under the Act contrary to such rules and regulations as the Commission may prescribe.⁴ Section 4c(b) provides in pertinent part as follows:

No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under [the Act], but not specifically set forth in section 2(a) of [the Act] prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe. . . .

Thus, the Commission is empowered under section 4c(b), to determine if and under what circumstances commodity option trading will be permitted. For example, the Commission could (a) prohibit all commodity option trading, (b)

character of, or is commonly known to the trade as, an "option" . . .), and transactions involving contracts of sale of a commodity for future delivery The interim rules announced today are effectuated pursuant to this authority as well as that contained in sections 4c and 8a of the Act.

* 7 U.S.C. 6c(a)(B) (Supp. IV, 1974). So that all regulations concerning commodity options will be in one place, for convenience, the Commission has incorporated the prohibition contained in section 4c(a)(B) as § 32.2(a) of the proposed interim regulations. Section 4c(a)(B) expressly forbids option transactions relating to those commodities which were regulated under the Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974 (Pub. L. No. 93-463, October 23, 1974), thereby continuing the Act's prohibition with respect to those commodities. Those previously-regulated commodities were: " . . . wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice" Section 2(a)(1) of the Act.

* Section 4c(b) governs options involving the newly-regulated commodities, namely "all other goods and articles [except onions] . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in" Section 2(a)(1) of the Act.

* 7 U.S.C. 6c(b) (Supp. IV, 1974). Section 4c(b) also provides that, if possible, rules were to be adopted within one year after the effective date of the section. However, the Commission advised Congress, in accordance with the provisions of section 4c(b), that it would be unable to meet the one-year time period ending April 21, 1976, within which to have comprehensive commodity option regulations in effect and that additional time would be required to carry out the Congressional mandate contained in section 4c(b). See 41 FR 16685 (April 21, 1976).

permit all commodity option trading "under such terms and conditions as the Commission shall prescribe," or (c) permit some forms of trading, subject to Commission rules and regulations, and prohibit others.

PRIOR PROPOSALS

On October 22, 1975, the Commission announced that it was considering the adoption of rules to regulate—or perhaps forbid—transactions in commodity options, including the promulgation of a temporary rule pending the adoption of a definitive regulatory program. See 40 FR 49360 (October 22, 1975).⁵

On February 20, 1976, the Commission proposed comprehensive regulations governing off-exchange commodity option transactions, including the so-called "dealer options". See 41 FR 7774 (February 20, 1976). The Commission has determined that, by the time of implementation of its second stage of regulations, only designated boards of trade and recognized foreign commodities exchange systems offering commodity options will be permitted, thereby, in effect, banning dealer options. Thus, the Commission has determined not to adopt the previously proposed regulations.⁶

In its release on the proposed regulations, the Commission invited interested persons to submit comments and to participate in oral hearings which were held in Washington, D.C., on March 8, 1976. The Commission also noted in its release that it was considering delaying the adoption of comprehensive regulations until it had an opportunity to study the recommendations of its Advisory Committee on the Definition and Regulation of Market Instruments. That Advisory Committee was assigned the responsibility, among other things, to submit a report and recommendations to the Commission on appropriate regulations or restrictions concerning commodity op-

¹Previously, on June 24, 1975, the Commission had adopted a broad antifraud rule applicable to commodity option transactions. See 40 Fed. Reg. 26505 (June 24, 1975). That rule, 17 C.F.R. § 30.01, will be redesignated as § 32.9 of the proposed interim regulations.

²Those proposed rules basically would have made it unlawful for any commodity option dealer, as defined in the rules, to offer to enter into, enter into or confirm the execution of any transaction subject to the proposed rules unless the dealer met certain financial requirements and registered with the Commission as a commodity option dealer. Registration as a commodity option dealer would have entailed the filing of detailed information in the form of an application. Both financial data and information about business practices were required. Also, the proposed rules required a dealer, in connection with offers to enter into commodity option transactions, to inform each prospective purchaser that the dealer had filed an application in connection with its registration with the Commission containing information about the dealer, the dealer's business and its financial condition and that copies of such filings were available for public inspection at all offices of the dealer and at the Commission's offices in Washington, D.C.

¹The basic thrust of the Commission's proposals and the time within which they are to be implemented were announced at a public meeting of the Commission held in Washington, D.C. on September 13, 1976.

²7 U.S.C. 6c (Supp. IV, 1974). The Commission also has general rule-making authority under section 8a of the Act, 7 U.S.C. 12a (Supp. IV, 1974). The Commission points out also that section 2(a)(1) of the Act, 7 U.S.C. 2 (Supp. IV, 1974), provides that the Commission shall have "exclusive jurisdiction" with respect to "accounts, agreements (including any transaction which is of the

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tions.* At the time of its proposal concerning off-exchange commodity option transactions, the Commission stated:

[A]lthough the proposed regulations relate to transactions which are not entered into on a contract market, the Commission is affirmatively considering permitting commodity option transactions to be traded on or subject to the rules of a contract market which have been approved by the Commission as adequate to effectuate the purposes of the Act. . . . Ultimately the Commission may adopt regulations which restrict commodity option transactions to trading on contract markets.*

The Commission, after carefully considering the comments received on its prior proposals, the presentations made at its oral hearing, and the report and recommendations of its Advisory Committee, has determined in large measure to do just that—to implement a test program for commodity option transactions, the effect of which will be to restrict commodity option transactions, other than certain specified "trade option" transactions, to domestic boards of trade or foreign commodities exchange systems designated or recognized by the Commission. As explained in more detail below, the proposed interim regulations have been primarily designed to provide adequate customer protections in the offer and sale of commodity options. However, in order to avoid any undue hardships on affected persons, the implementation of this regulatory program will be phased in gradually so that commodity option transactions lawfully entered into prior to the effective date of the proposed interim regulations will not be affected, and, during the period in which only the interim regulations are in effect, commodity option transactions will be permitted to be entered into in accordance with the terms of the interim regulations. Nevertheless, the Commission wishes to emphasize that, when the second stage of the Commission's regulations becomes effective, it will no longer be permissible to offer or to sell commodity options or to enter into commodity option transactions in the United States except in accordance with those regulations, i.e., only on or through designated domestic boards of trade or recognized foreign commodities exchange systems.

At the outset the Commission wishes to stress certain points concerning the proposed interim regulations and how they will interact with the second stage regulations which the Commission will shortly propose:

1. Section 32.2(b) of the proposed interim regulations provides that commodity option transactions involving commodity futures contracts traded on or subject to the rules of Commission-designated contract markets or involving the prices of such contracts are prohibited except under such terms and

conditions as the Commission shall prescribe. The Commission believes that, under the Act, particularly sections 4c (a) (C) and 4h, it is unlawful to trade options involving domestically traded futures contracts or the prices of such contracts otherwise than by or through a member of a contract market and subject to the rules thereof. However, since the Commission has been advised that such commodity option transactions are being offered and entered into in the United States, in order to avoid any question with respect to this issue, the Commission has decided to set forth an express codification of the Commission's view in proposed § 32.2(b). The Commission recognizes that the effect of proposed § 32.2(b) would also be to prohibit commodity option transactions effected even on or subject to the rules of contract markets, since the Commission has not yet prescribed the terms and conditions under which such trading will be permitted. Such terms and conditions will be the subject of the second stage of regulations to be proposed by the Commission. Trading in commodity options involving domestically traded futures contracts on any contract market will not be permitted until there are comprehensive regulations in effect and the contract market has complied with such regulations. Thus, the Commission's proposed interim regulations prohibit all commodity option transactions involving domestically traded futures contracts or prices of such contracts, including those traded on or subject to the rules of a contract market.

2. The interim regulations are designed to regulate those commodity option transactions which are not otherwise prohibited (i.e., not otherwise set forth in proposed § 32.2). At the present time, the Commission is aware that so-called "London options" are being offered in the United States, as well as the so-called "dealer options" on physical commodities. Briefly, the interim regulations will have the following effect on these types of commodity option transactions:

A. Under proposed § 32.3(a), on and after January 17, 1977 (approximately 105 days from the date of publication of this notice), it will be unlawful for any person to accept funds or other property from an option customer as payment of the purchase price of a commodity option unless the person is registered as a futures commission merchant under the Act. Until such time, of course, persons may continue to accept funds or other property without being so registered.

B. Under proposed § 32.3(b), on and after January 17, 1977, it will be unlawful for a person to solicit or accept orders for commodity options or for an individual to be associated with any such person, unless registered as a futures commission merchant or an associated person of such futures commission merchant, respectively, under the Act.

* London commodity exchange options cleared through the International Commodities Clearing House and commodity options written by or through the individual members of the London Metals Exchange.

The Commission wishes to emphasize that the Commission fully intends to implement these regulations and that the registration process (See (A) and (B) above) takes time. Therefore, as explained in more detail below, the Commission suggests that affected persons file their registration applications as soon as possible and not defer filing until the effective date of the regulations.

The Commission points out that, upon adoption of proposed § 32.3 (a) and (b), writers of commodity options or other persons assuming financial responsibility for commodity options may offer or sell commodity options in the United States only through registered futures commission merchants and their registered associated persons. In this connection, the Commission wishes to advise affected persons that regulation § 1.19—which prohibits a futures commission merchant from issuing or otherwise assuming financial responsibility for a commodity option transaction—will not be repealed by the proposed interim regulations. Consequently, it will continue to be unlawful for a futures commission merchant to assume financial responsibility, whether by contract or by operation of law, for a commodity option transaction. The Commission will consider the repeal of § 1.19 in connection with the proposed second stage of its regulations. If repealed, futures commission merchants would then be permitted to issue or otherwise assume financial responsibility for commodity option transactions in accordance with the terms of those regulations.

C. Immediately upon the effective date of the interim regulations, under proposed § 32.6 any person which receives funds or property from an option customer as payment of the purchase price for a commodity option must segregate from its assets, and treat as belonging to the option customer, all such funds and property received, including any amounts characterized as sales commissions or similar fees. The funds and property must be segregated (i) in the United States and (ii) until the option expires or, if the customer exercises the option, until the customer's rights under the option have been satisfied. As noted above, on and after January 17, 1977, only registered futures commission merchants may receive funds or property from option customers in connection with a commodity option transaction. Thus, writers and other persons who assume financial responsibility for commodity options may receive such funds and property from an option customer only until January 17, 1977, but must segregate and treat those assets as provided in proposed § 32.6. After January 17,

* Because the repeal of § 1.19 would necessitate substantial revisions of regulation § 1.17 (in order to assure the financial responsibility of futures commission merchants), the Commission did not feel that these revisions could be made without additional study and therefore determined not to propose the repeal of § 1.19 as part of the proposed interim regulations. See 17 C.F.R. §§ 1.17 and 1.19.

* See 40 FR 32866 (August 5, 1975). The Advisory Committee's report, which was transmitted to the Commission on July 6, 1976, is published as a special supplement numbered 26 to the CCH Commodity Futures Law Reporter (July 15, 1976).

* 41 FR 7774 (February 20, 1976).

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1977, such persons may not receive the funds or property except from a futures commission merchant which accepted them from the option customer and then only after the segregation requirements have been satisfied by the futures commission merchant. The Commission is aware that proposed § 32.6 may, in certain cases, require "double segregation." For example, in the case of the sale of London options, a person receiving the funds from an option customer in the United States as payment for the option may not remit those funds to London in order to obtain or maintain the option position with a London broker. The Commission believes that the proposed segregation requirements are an essential customer protection to be afforded commodity option customers in the United States. The Commission recognizes, however, that its proposed segregation requirements may impose a financial hardship on some affected persons, and as noted in more detail below, requests specific comments on these requirements, particularly alternatives which could provide substantially equivalent customer protections.

D. Upon the effective date of the proposed interim regulations, § 1.17 of the regulations will be amended to provide that a futures commission merchant engaged in commodity option transactions must have an adjusted working capital which at a minimum equals \$50,000. As indicated above, the Commission anticipates that when the second stage of its regulations becomes effective, there will be additional, substantial amendments to § 1.17 in order to assure the financial responsibility of futures commission merchants engaged in commodity option transactions.

E. Under proposed § 32.5, upon the effective date of the interim regulations, persons soliciting or accepting orders for commodity option transactions must make summary disclosure to option customers, prior to the entry into the commodity option transaction, of various aspects of the transaction, including information regarding all fees and charges to be paid by the option customer in the transaction, such as premiums, mark-ups on premiums, and sales commissions. The Commission anticipates that the second stage of its regulations regarding commodity options will impose additional, more detailed, disclosure requirements on such persons.

A section-by-section explanation and the text of the Commission's interim regulations are set forth below:

DEFINITIONS

Section 32.1 of the proposed rules defines certain terms used in the rules. For convenience, the terms "commodity option transaction" and "commodity option" are each defined in § 32.1(a) to mean any such transaction or agreement in interstate commerce which the Commission is authorized to regulate under sections 2(a)(1) and 4(c) of the Act.¹⁷

¹⁷ See text accompanying notes 2, 3 and 4 *supra*.

Section 32.1(b) defines "interstate commerce" to have the same meaning as set forth in sections 2(a) and 2(b) of the Act.¹⁸ Section 32.1(c) defines "option customer" as any person who, directly or indirectly, purchases or otherwise acquires for value any interest in a commodity option,¹⁹ but does not include a person required to register as a futures commission merchant in accordance with the proposed rules. Futures commission merchants were excluded from the definition of "option customer" to avoid the implication that futures commission merchants are "option customers" of their principals—who may be option writers—when acting in an agency capacity in commodity option transactions. If the definition of option customer were construed to include futures commission merchants, then in accordance with the provisions of proposed § 32.3(a),²⁰ a writer of an option, for example, who markets such options through a futures commission merchant, would technically be required to register as a futures commission merchant at the time he received from an option customer—the futures commission merchant—either money, securities or property as payment of the purchase price in connection with the commodity option transaction. As a result of the retention of § 1.19 of the regulations, the Commission does not intend that option writers be required to register as futures commission merchants under the interim regulations. Accordingly, it has excluded futures commission merchants from the definition of option customer.

Proposed § 32.1(d) defines "purchase price" to mean the total actual cost paid or to be paid, directly or indirectly, by an option customer for entering into and maintaining an interest in a commodity option transaction, by whatever name called. Subsumed within the definition of purchase price are the premium, mark-ups on the premium, as well as the costs, fees, and other charges comprising the purchase price. Proposed § 32.1(e) defines "striking price" to mean the price at which an option customer may purchase or sell the commodity or the contract of sale of a commodity for future delivery which is the subject of a commodity option transaction.

PROHIBITED TRANSACTIONS

As indicated above, in order to have commodity option requirements self-contained in one set of regulations, proposed § 32.2(a) of the interim regulations incorporates the existing statutory prohibition on the offer or sale of commodity options involving previously regulated commodities. And, as previously explained, proposed § 32.2(b) expressly prohibits the offer or sale of commodity options involving domestically traded futures contracts.

¹⁷ 7 U.S.C. 2, 4 (Supp. IV, 1974).

¹⁸ As set forth in § 32.1(a) the terms commodity option and commodity option transaction are used interchangeably in the proposed rules.

¹⁹ The provisions of this section are explained in more detail below.

UNLAWFUL COMMODITY OPTION TRANSACTIONS

Proposed § 32.3(a) provides that on and after January 17, 1977, it shall be unlawful for any person to accept any money, securities, or property (or to extend credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction unless such person is registered as a futures commission merchant under the Act.²¹ Proposed § 32.3(b) provides that on and after January 17, 1977, it shall be unlawful for any person to solicit or accept orders (other than in a clerical capacity) for the purchase or sale of any commodity option, or to supervise any person or persons so engaged, unless such person is (1) registered as a futures commission merchant under the Act, or (2) if such person is an individual, registered as an associated person of a specified futures commission merchant under the Act. In addition, it shall be unlawful for any futures commission merchant to permit an individual to become or remain associated with such futures commission merchant in specifically enumerated capacities if such futures commission merchant knew or should have known that such individual was not registered as an associated person.

The Commission wishes to stress that the registration requirements apply to all persons who accept orders for commodity options, irrespective of whether the order is accepted directly from an option customer. Thus, if a futures commission merchant utilizes the services of another firm in order to arrange for the execution of the order of an options customer, the other firm is also required to register as a futures commission merchant.

The Commission realizes that the term futures commission merchant in section 2(a)(1) of the Act is not defined to include persons engaged in commodity option activities, and it is not intended to require that persons registering as futures commission merchants in accordance with the provisions of the interim regulations be required to solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of a contract market. Rather, the Commission has determined, pursuant to its plenary power to regulate commodity option transactions in sections 2(a)(1) and 4(c) of the Act, to entrust option activities only to futures commission merchants and associated persons of specified futures commission merchants, inasmuch as these are categories of registrants with which the Commission and the public are already familiar. This will allow the Commission to regulate commodity option activities

²¹ The Commission proposes to amend § 1.3 (p) of its regulations, 17 CFR 1.3(p), defining the term "futures commission merchant", to add a new subsection (2) which would include within the definition of the term "futures commission merchant," any person required to register as a futures commission merchant by virtue of the interim regulations.

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in a less complicated fashion. For example, the proposed interim regulations would automatically pick up the standards for registration and denial of registration contained in the Act and the Commission's interpretation thereof; they would automatically make applicable the reparation procedures under the Act; and they would allow for the incorporation of financial standards and related requirements in the context of revisions to § 1.17 of the regulations.

The Commission is also mindful of the fact that it proposes to exclude associations, partnerships, corporations, trusts and any other entities from the category of persons who may register as associated persons in order to comply with the provisions of section 32.3(b). The Commission believes that entities engaged in soliciting or accepting orders for the purchase or sale of commodity options should be registered as futures commission merchants, and that the associated person category of registrant in the commodity options area should be limited to individuals employed by such entities, irrespective of whether they may presently be classified as associated persons or agents of futures commission merchants under Section 4k of the Act, 7 U.S.C. 6k (Supp. IV, 1974).

It should be noted that the anticipated effective date of these rules is November 22, 1976. The registration provisions, however, do not go into effect until 60 days thereafter. This is to allow persons sufficient time to submit, and for the Commission to process, applications for registration. Processing of applications normally take approximately 60 days. Therefore, as indicated above, the Commission urges persons wishing to register as futures commission merchants or associated persons to submit their applications promptly. A person who defers filing an application until the effective date of the regulations runs the risk that the application may not be processed on a timely basis; a person who does not file an application until after the effective date increases the risk that the application will not be processed by the time the registration requirements go into effect. The Commission intends to expedite the processing of such applications, and a prompt filing will enable the Commission to do so on a timely basis.

Section 32.3(c) provides that persons required to register as futures commission merchants or as associated persons in accordance with §§ 32.3 (a) and (b), which furnish the services specified in that portion of section 2(a)(1) of the Act defining the term "commodity trading advisor", shall not be included in the term "commodity trading advisor", if, at the time such services are furnished, such person is registered as a futures commission merchant or as an associated person under the Act and the furnishing of such services is solely incidental to the conduct of such person's activities requiring such registration. The Commission has previously expressed the view that generally persons who are offering commodity options to the public should register with the Commission as commodity trading

advisors.¹⁷ In CFTC Staff Interpretative Letters Numbered 76-13 and 76-13a,¹⁸ the Commission's Office of General Counsel stated that the Commission's view applied to futures commission merchants. In view of the fact that persons soliciting or accepting orders for commodity options are to be required to register either as futures commission merchants or associated persons under the proposed interim regulations, the Commission has determined that, once such persons are in fact registered, the registration of such persons as commodity trading advisors would serve no additional public interest. Accordingly, while the Commission believes that the staff interpretation is a correct interpretation of existing law, compliance with that interpretation will not be necessary upon the adoption of the interim regulations, and, pending such adoption, the Commission has determined that it will not take any enforcement action against any futures commission merchant, based solely on its failure to register as a commodity trading advisor in compliance with such interpretation from and after the date of the publication of this notice.

Those persons which are already registered as futures commission merchants or associated persons under the Act, and which would be required to register as such by virtue of these proposed rules, need not re-register in those categories, but should immediately notify the Commission in writing, specifying the date such person commenced or intends to commence engaging in activities otherwise requiring registration under these proposed rules. This provision is set forth in proposed § 32.3(d).

EXEMPTIONS

The Commission previously indicated that no public interest would be served by regulatory provisions governing commercial commodity option transactions with certain users, producers or consumers, and previously proposed a "trade option" exemption for such persons.¹⁹ The Commission has again considered this issue in light of the comments received on its prior proposal, as well as the recommendations from its Advisory Committee on Market Instruments, and has concluded that there is no substantial public interest to be served by requiring the registration of certain producers, processors, commercial users, or merchants who engage exclusively in commercial-type transactions. The Commission believes that its antifraud rule governing commodity option transactions achieves the full regulatory objective in such cases. Accordingly, except for the provision of its antifraud rule (§ 32.9) and otherwise prohibited transactions (§ 32.2), the Commission has determined to exempt from the operation of these rules the offer of commodity option transactions by a person who has a reasonable basis to believe that the option is being

offered to a purchaser referred to in proposed § 32.4(a) and that the purchaser is being offered or acquires such option for purposes related to its business. Of course, to the extent that a person offers or sells commodity option transactions to persons other than, or in addition to such purchasers, compliance with these rules would be required.

The Commission intends to monitor the effect the trade option exemption contained in § 32.4(a) has in the marketplace to ascertain whether it is necessary or appropriate. The Commission wishes to re-emphasize that the exemptive provisions expressly do not exclude any person from the proscriptions in the Commission's general antifraud rule governing commodity option transactions presently in effect, which is to be redesignated as § 32.9 of the proposed rules. The existing antifraud rule applies, and will continue to apply, to all offers and sales of commodity option transactions subject to Commission regulation whether or not these transactions are subject to or exempt from the provisions of any of the Commission's rules affecting commodity options.

Additionally, proposed § 32.4(b) provides that the Commission may, by order, upon written request or upon its own motion, exempt any other person, either unconditionally or on a temporary or other conditional basis, from any provisions of these rules, other than those of §§ 32.2 (prohibited transactions), 32.8 (unlawful transactions) and 32.9 (antifraud rule), if it finds, in its discretion, that it would not be contrary to the public interest to grant such exemption. At the present time, the Commission contemplates no additional exemptions but has inserted this provision in the proposed regulations to permit maximum Commission flexibility. Since the ultimate purpose of the Commission's regulations will be to implement a rigidly controlled option test program, exemptions would be considered only in the most extraordinary of circumstances.

DISCLOSURE

Proposed § 32.5 sets forth the disclosure which a person soliciting a commodity option transaction must provide to an option customer not less than 24 hours prior to the entry into the commodity option transaction. Commodity option customers are required to be provided with a summary disclosure statement setting forth (1) the actual amount of the purchase price and the method by which the premium is established, including a separate listing of the premium, mark-ups on the premium, costs, fees and other charges comprising the purchase price; (2) a statement of (i) the services to be provided for the separate elements comprising the purchase price, (ii) the striking price and the method by which the striking price is established, (iii) the total quantity or quality of the commodity which may be purchased or sold upon exercise of the commodity option or which underlies the contract of sale for future delivery which may be purchased or sold upon exercise

¹⁷ See 40 FR 49361, n. 11 (October 22, 1975).

¹⁸ CCH Commodity Futures L. Rep 120,174 (Interpretative letter 76-13a has not yet been published in this service).

¹⁹ See 41 FR 7776 (February 20, 1976).

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of the commodity option, and (iv) any and all additional costs which may be incurred by the option customer if the option is exercised, including storage costs, interest charges, commissions (whether denominated as sales commissions or otherwise), and all similar fees and charges; (3) the price level that the underlying commodity or the underlying contract of sale for future delivery must reach during the life of the option for the option customer to realize a profit in the commodity option transaction, together with an explanation of the effect of applicable foreign currency fluctuations; (4) a bold-faced statement on the first page of the disclosure statement setting forth certain specific cautions regarding commodity option transactions; and (6) a statement of certain risks to be considered by the customer before entering into the commodity option transaction. The Commission wishes to emphasize that this disclosure should be clear, intelligible and understandable to any person reading it. This disclosure statement is required to be furnished to option customers in advance of purchase so as to familiarize them with certain aspects of the option transaction. The Commission is aware that a significant number of commodity option transactions currently are being offered and sold through the use of high-pressure sales tactics to persons who are relatively unfamiliar with the commodities markets generally, and with commodity options in particular. The Commission is also aware that at the present time even when disclosure is made to option customers, it is often inaccurate or misleading, either in content, presentation, or both. Given the interim nature of the proposed rules, the disclosure statement required to be furnished by § 32.5 is by no means intended to convey the impression that the items contained therein are the only things which need be disclosed to prospective customers, and the Commission would encourage persons soliciting prospective option customers to provide them with sufficient information to evaluate the transaction more fully and the futures commission merchant and/or associated person through whom such customers are dealing, as well as their financial conditions. In this connection, as noted above, when the Commission proposes the second stage of its regulations, it expects to require additional, more detailed information to be disclosed to prospective option customers.

The Commission understands that if an option customer purchases an option on a contract of sale of a commodity for future delivery which is traded on a foreign commodity exchange, the solicitor of such option would not always be able to provide the option customer with certain "price" information until the trade is executed. In that event proposed § 32.5 (b) provides that to the extent the actual price information called for by paragraphs (a) (1), (2) and (3) of § 32.5 is not known at the time the disclosure statement is to be delivered to the prospective option customer, a good faith

estimate of such information should be provided as part of the disclosure statement, and upon execution of the commodity option transaction for the option customer, the person required to deliver the disclosure statement shall immediately provide all actual price information in writing to the option customer.

SEGREGATION

The Commission has provided in proposed § 32.6 that any person which accepts money, securities or property from an option customer as payment of the purchase price in connection with a commodity option transaction shall segregate such money, securities and property in the United States and shall treat and deal with such assets as belonging to such option customer until expiration of the term of the option or, if the option customer exercises the option, until all rights of the option customer under the commodity option have been fulfilled. The Commission wishes to emphasize that § 32.6 requires that assets must be segregated in the United States, so that such assets will not be subject to the attachment or other laws or requirements of any other nation. The Commission views these requirements as essential to protect at least the basic investment of commodity option customers as well as to assure, to the extent feasible, the financial integrity of option transactions. In the Commission's view, these segregation requirements are a cardinal tenet of commodities regulation, and will help to prevent fraud. Absent segregation, these assets could be used by a person in its general operations. In addition, absent segregation, these assets might be subject to the claims of general creditors of the person accepting them. As noted above, the Commission is aware that the segregation requirements could result in "double segregation," particularly where futures commission merchants or other persons are engaged in the offer and sale of London options. The Commission is further cognizant of the fact that this segregation requirement may impose a financial strain upon the vast percentage of persons presently engaged in the offer and sale of commodity options. Accordingly, the Commission encourages interested persons, particularly those engaged in the offer and sale of London commodity options, to submit comments on the Commission's segregation proposals and to suggest alterations which will provide adequate customer protections. In submitting any alterations, commentators should be aware that, in the Commission's view, what is of paramount importance in its fundamental customer protection aspects. In submitting any alternative proposals, commentators should be aware that, in the Commission's view, what is of paramount importance is that option customers be assured, at the very least, that the assets which they put up to purchase the option will be safe during the term of the option and be available to be refunded to option customers in the event that an option customer exercises the option but is unable to obtain satisfaction of the obligations owing to him because of the

insolvency of the futures commission merchant or its principals.

The provisions of § 32.6 are patterned essentially after the requirements for segregation of customer funds in section 4d(2) of the Act and regulation §§ 1.20 (a) (customers' money, securities, and property to be segregated and separately accounted for), 1.25 (investment of customers' funds), 1.26(a) (deposit of obligations purchased with customers' funds), 1.27(a) (record of investments), 1.28 (appraisal of obligations purchased with customers' funds), 1.29 (increment or interest resulting from investment of customers' funds), and 1.32 (segregated accounts; daily computation and records).²

The Commission had originally intended to permit futures commission merchants to exclude sales commissions from the assets required to be segregated. Because of the difficulty of defining "premium" and "commissions", this might have permitted unscrupulous persons to characterize the major portion of the purchase price as a "sales commission" and thereby tend to encourage attempts to evade the segregation requirements. The alternative would have been to impose a maximum percentage on the amount of permissible sales commissions, but the Commission believes that it should not engage in this practice. Accordingly, the Commission has decided that it is in the public interest that futures commission merchants segregate all assets received from customers as payment of the purchase price in connection with a commodity option transaction and treat such assets as belonging to option customers. The Commission specifically requests comments on whether it should permit some portion of the purchase price not to be segregated, and if so, how that portion could be determined.

The Commission is further aware that its segregation requirements may have to be modified in its second stage regulations to take into account option trading on boards of trade designated by the Commission and on recognized foreign commodities exchange systems.

BOOKS AND RECORD KEEPING

Proposed § 32.7 (a) and (b) require persons receiving the purchase price for a commodity option from an option customer to maintain full, complete and systematic records of all such transactions. Among other things, such persons are required to keep: all orders, signature cards, books of record, journals, ledgers, cancelled checks, copies of all statements of purchase, exercise or lapse, and reports, letters, disclosure statements required by proposed § 32.5, solicitation or advertising material, and all other literature or written advice distributed to option customers or prospective option customers; the true name and address of each commodity option customer or prospective commodity option customer solicited; and the true name and address of each maker, underwriter, issuer or other person who

² 17 CFR §§ 1.20(a), 1.25, 1.26(a), 1.27(a), 1.28, 1.29 and 1.32.

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assumes or purports to assume any financial responsibility for the fulfillment of any commodity option transaction engaged in by such person. Under proposed § 32.7(c), persons accepting orders from persons other than an option customer (for example, a corresponding futures commission merchant of a futures commission merchant dealing directly with an option customer) must keep similar records to the extent necessary to reflect their participation in the transactions.

In addition, under proposed § 32.7(d) each person which accepts an order for a commodity option, whether from an option customer or any other person, must prepare a written record of that order, including an account identification and order number and must record the date and time the order is accepted, is transmitted for execution, and, if the order is executed, the date and time of execution. And each such person which accepts the purchase price of the commodity option from the option customer must, upon receipt of confirmation that the order was executed, notify the option customer of the date that the order was executed.

Under proposed § 32.7(e), all the records required to be maintained must be kept for the period specified in regulation § 1.31,¹⁷ which is five years, and must be open to inspection at all times during such time by any authorized representative of the Commission of the United States Department of Justice.

The Commission believes that the records and bookkeeping requirements are important so as to enable the Commission to examine the records of all aspects of commodity option transactions offered and sold to option customers, and to assure that persons maintain proper internal control of their financial operations.

UNLAWFUL REPRESENTATIONS

Proposed § 32.8 makes it unlawful for any futures commission merchant or associated person engaged in commodity option transactions to claim that the Commission, by declaring a registration effective or otherwise, has approved either the registrant or any commodity option transaction to be engaged in by the registrant. While the Commission will seek to prevent the dissemination of false or misleading information by registrants, it cannot conduct an investigation in every instance to determine the accuracy or adequacy of the information contained in an application for registration or in the disclosure statement required by proposed § 32.5 of the interim regulations. Consequently, registration with the Commission cannot, and does not, indicate Commission approval of the registrant or of the transactions in which it may engage. This rule does not preclude a futures commission merchant or associated person from stating that it is registered, if that is true, and if such statement is not misleading under the circumstances in which the statement is made.

¹⁷ 17 CFR 1.31.

ANTIFRAUD

Proposed § 32.9, the Commission's anti-fraud rule governing commodity option transactions, has been included as a part of the proposed interim rules so that all the rules affecting commodity option transactions will be in one place in the Code of Federal Regulations. This section is the same rule that is presently in effect, contained in 17 CFR 30.01, modified to incorporate certain of the definitions set forth in the proposed interim rules. The proposed redesignation of § 30.1 as § 32.9 is technical only; it will have no substantive effect on fraudulent activity prior to, on, or after the effective date of § 32.9.¹⁸

The Commission wishes to advise affected persons that, upon adoption of the proposed interim regulations, it would view any attempt to evade their requirements—such as an attempt to avoid the segregation requirements by soliciting options customers in this country and suggesting to the customers that they deal directly with a foreign affiliate of the registrant or other person located outside the United States—as a violation of the antifraud provision.

OPTION TRANSACTIONS ENTERED INTO PRIOR TO THE EFFECTIVE DATE OF THE PROPOSED INTERIM REGULATIONS

Proposed § 32.10 makes clear that the proposed rules are to have prospective effect only and do not apply to commodity option transactions lawfully entered into prior to the effective date of the rules. However, to the extent stated above, §§ 32.2 and 32.9 are codifications of the prohibitions of existing law, so that nothing contained in § 32.10 should be construed to imply that the transactions referred to in § 32.2 or 32.9 could have been or may be lawfully entered into prior to the effective date of the interim regulations.

AMENDMENTS TO § 1.17

The Commission proposes to amend § 1.17 to require that any futures commission merchant engaging in commodity option transactions referred to in Part 32 of the proposed regulations would be required to have and to maintain at all times adjusted working capital equal to or in excess of whichever of the following is greater: (1) \$50,000 or (2) the sum of the safety factors described in § 1.17 with respect to both proprietary and customers' accounts plus five percent of the applicant's aggregate indebtedness. A futures commission merchant who is exempt from the financial requirements of § 1.17(a) would also be required to maintain minimum adjusted working capital of at least \$50,000, computed in accordance with the bylaws, rules, regulations or resolutions of the contract market which serve as the basis for such exemption.

¹⁸ Judicial Interpretations of § 31.01 would, of course, continue to be applicable to new section 32.9. See *CFTC v. J. S. Loie & Associates Options, Ltd.*, CCH Com. Fut. L. Rep. ¶20,198 (S.D.N.Y. Aug. 12, 1976).

The Commission believes that the \$50,000 adjusted working capital requirement for futures commission merchants engaged in options activity is necessary to provide a cushion against losses which could arise as a result of any number of factors, such as dishonesty, incompetence, insufficient or inadequate segregation.

The Commission also proposes to amend § 1.17 to add a new paragraph (c) (9) defining the term "customer" to include an "option customer" as defined in the proposed rules. This is necessary to make § 1.17 applicable to commodity option transactions.

In consideration of the foregoing, the Commission, pursuant to its authority contained in sections 2(a)(1), 4c(a), 4c(b) and 8a of the Act, 7 U.S.C. 2, 6c(a), 6c(b) and 12a (Supp. IV, 1974), hereby proposes to amend Chapter 1 of Title 17 of the Code of Federal Regulations effective November 22, 1976, by amending §§ 1.3(p) and 1.17, by deleting § 30.01 and by adding a new Part 32 as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. Section 1.3(p) is amended by adding a "(1)" after the word "means" and before the word "individuals", by deleting the period and adding the word "and" after the word "therefrom" and by adding the following:

§ 1.3 Definitions

(p)
(2) shall include any person required to register as a futures commission merchant under the Act by virtue of Part 32 of this chapter.

2. Section 1.17 is amended to revise paragraphs (a) and (b) and to add paragraph (c) (9) as follows:

§ 1.17 Minimum financial requirements.

(a) Except as provided in paragraphs (b) (1) and (b) (2) of this section, no person applying for registration as a futures commission merchant shall be so registered unless he has adjusted working

¹⁹ In proposing the regulations hereinafter set forth, the Commission has, in accordance with section 15 of the Act, 7 U.S.C. 19 (Supp. IV, 1974) taken into consideration the public interest to be protected by the antitrust laws. While it recognizes that the financial, segregation and other criteria imposed as prerequisites to allowing a person to enter into or continue in the commodity options business, may result in some lessening of competition, the Commission believes that the proposed rules are a necessary minimum for effectuating the purposes and policies of the Act which require that the Commission assure the financial solvency of option transactions and prevent fraud or manipulation. The Commission has determined that minimum financial and other requirements are essential to public protection under the Act. Accordingly, the Commission believes that, in imposing the minimum financial requirements and the other requirements of the proposed regulations, it has taken the least anticompetitive means of achieving the objectives, policies and purposes of the Act.

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capital equal to or in excess of whichever of the following is greater: (1) \$10,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(b) (1) Except as provided in paragraph (b) (2) of this section, no person registered as a futures commission merchant shall engage in commodity option transactions referred to in Part 32 of this chapter unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (1) \$50,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each such person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(2) The requirements of paragraphs (a) and (b) (1) of this section shall not be applicable if the applicant for registration or registrant is a member of a contract market and conforms to minimum financial standards and related reporting requirements set by such contract market in its bylaws, rules, regulations or resolutions approved by the Commission. *Provided, however,* That such a futures commission merchant who engages in option transactions referred to in Part 32 of this chapter shall at all times maintain a minimum capital of \$50,000 computed in accordance with the applicable bylaws, rules, regulations, or resolutions of such contract market which have been approved by the Commission.

(c) . . . (9) The term "customer" shall include an "option customer" as defined in Part 32 of this Chapter.

PART 30—FRAUD IN CONNECTION WITH COMMODITY TRANSACTIONS

§ 30.01 [Removed]

1. Section 30.01 is removed.

PART 32—REGULATION OF COMMODITY OPTION TRANSACTIONS

2. Part 32 is added to read as follows:

- | | |
|-------|--|
| Sec. | |
| 32.1 | Definitions. |
| 32.2 | Prohibited transactions. |
| 32.3 | Unlawful commodity option transactions. |
| 32.4 | Exemptions. |
| 32.5 | Disclosure. |
| 32.6 | Segregation. |
| 32.7 | Books and recordkeeping. |
| 32.8 | Unlawful representations. |
| 32.9 | Fraud in connection with commodity option transactions. |
| 32.10 | Option transactions entered into prior to the effective date of this Part. |

AUTHORITY: Secs. 2(a)(1), 4c(a), 4c(b), 8a, Commodity Futures Act (7 U.S.C. 2, 6c (b) and 12a (Supp. IV, 1974)).

§ 32.1 Definitions.

As used in this Part—

(a) "Commodity option transaction" and "commodity option" each means any transaction or agreement in interstate commerce which is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty" involving any commodity regulated under the Act other than wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice;

(b) "Interstate commerce" shall be construed and have the same meaning as set forth in sections 2(a) and 2(b) of the Act;

(c) "Option customer" means any person who, directly or indirectly, purchases or otherwise acquires for value any interest in a commodity option, but shall not include a person required to register as a futures commission merchant in accordance with this part;

(d) "Purchase price" means the total actual cost paid or to be paid, directly or indirectly, by an option customer for entering into and maintaining an interest in a commodity option transaction, by whatever name called; and

(e) "Striking price" means the price at which an option customer may purchase or sell commodity or the contract of sale of a commodity for future delivery which is the subject of a commodity option transaction.

§ 32.2 Prohibited transactions.

No person may offer to enter into, confirm the execution of, or maintain a position in, any transaction in interstate commerce involving—

(a) Wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice, or

(b) Any contract of sale of any commodity for future delivery traded on or subject to the rules of any contract market or involving the prices of such contracts, except under such terms and conditions as the Commission shall prescribe;

if the transaction is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty".

§ 32.3 Unlawful commodity option transactions.

(a) On and after January 17, 1977, it shall be unlawful for any person to accept any money, securities, or property (or to extend credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction unless such person is registered as a futures commission merchant under the Act and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked.

(b) On and after January 17, 1977, it shall be unlawful for—

(1) Any person to solicit or accept orders (other than in a clerical capacity) for the purchase or sale of any commodity option, or to supervise any person or persons so engaged, unless such person is—

(i) Registered as a futures commission merchant under the Act, or

(ii) If such person is an individual, registered as an associated person of a specified futures commission merchant under the Act;

and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked; and

(2) Any futures commission merchant to permit an individual to become or remain associated with such futures commission merchant as a partner, officer or employee (or in any similar status or position involving similar functions) in any capacity involving such solicitation, acceptance or supervision if such futures commission merchant knew or should have known that such individual was not registered as an associated person or that such registration has expired, been suspended (and the period of suspension has not expired) or revoked;

(c) A person required to register as a futures commission merchant or as an associated person in accordance with this Part which furnishes the services specified in that portion of section 2(a)(1) of the Act defining the term "commodity trading advisor" shall not be included in the term commodity trading advisor if:

(1) At the time such services are furnished, such person is registered as a futures commission merchant or as an associated person under the Act, and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked; and

(2) The furnishing of such services is solely incidental to the conduct of such person's activities requiring such registration.

(d) A person registered as a futures commission merchant or an associated person under the Act, who is required to register as such by virtue of this Part, need not re-register as such but shall immediately notify the Commission in writing, specifying the date such person commenced or intends to commence engaging in activities otherwise requiring registration under this part.

§ 32.4 Exemptions.

(a) Except for the provisions of §§ 32.2 and 32.9, which shall in any event apply to all commodity option transactions, the provisions of this Part shall not apply to a commodity option offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and that such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such.

(b) The Commission may, by order, upon written request or upon its own motion, exempt any other person, either unconditionally or on a temporary or other conditional basis, from any provisions of this Part, other than §§ 32.2, 32.8 and 32.9, if it finds, in its discretion, that it would not be contrary to the public interest to grant such exemption.

§ 32.5 Disclosure.

(a) Prior to the entry into any commodity option transaction, each prospective option customer shall be furnished with a summary disclosure statement by the person soliciting the order therefor not less than 24 hours prior to the entry into the commodity option transaction. Except as provided in paragraph (b) of this section, the disclosure statement shall contain the following:

(1) The actual amount of the purchase price and the elements comprising the purchase price, including a separate listing of the premium, markups on the premium, costs, fees and other charges, as well as the method by which the premium is established.

(2) A statement of:

(i) The services to be provided for the separate elements comprising the purchase price,

(ii) The striking price, and the method by which the striking price is established,

(iii) The total quantity and quality of the commodity which may be purchased or sold upon exercise of the commodity option or which underlies the contract of sale for future delivery which may be purchased or sold upon exercise of the commodity option, and

(iv) Any and all additional costs which may be incurred by the option customer if the option is exercised, including, but not limited to, the amount of storage, interest, commissions (whether denominated as sales commissions or otherwise) and all similar fees and charges;

(3) The price level which the underlying commodity or the underlying contract of sale for future delivery must reach during the life of the option in order that the option customer realize a profit in the commodity option transaction, together with a clear explanation of the effect of any foreign currency fluctuations if the option is to be executed on or through the facilities of a foreign board of trade;

(4) The following boldface statement on the first page of the disclosure statement:

Because of the volatile nature of the commodities markets, the purchase of commodity options are not suitable for many members of the public. A person should not purchase a commodity option unless he is prepared to sustain a total loss of the purchase price of the commodity option. Such transactions should be entered into only by persons who are aware of the potential for loss and who understand the nature and extent of their rights and obligations. These commodity options have not been approved or disapproved by the Commodity Futures Trading Commission nor has the Commission passed upon the accuracy or adequacy of this statement. Any representation to the contrary is a violation of the Commodity Exchange Act and the regulations; thereunder; and

(5) Statements to the effect that:

(i) Specific market movements of the commodity or contract of sale of a commodity for future delivery underlying the option cannot be accurately predicted, and

(ii) Generally, an option customer will be unable to sell his option in any market to recover any of the purchase price, but rather may only liquidate by exercising the option before the expiration date of the option or by entering into an offsetting transaction.

(b) To the extent that any of the actual price information required to be disclosed by the relevant portions of paragraphs (a) (1), (2) and (3) of this section is not known at the time the disclosure statement is to be delivered to the option customer, the person required to deliver the disclosure statement shall deliver as part of the disclosure statement, at the time specified, all the other information required by paragraph (a) of this section, as well as a good faith estimate of such price information, and shall provide all actual price information in writing to the option customer immediately upon the execution of the commodity option transaction for the option customer.

§ 32.6 Segregation.

(a) Any person which accepts money, securities or property from an option customer as payment of the purchase price in connection with a commodity option transaction shall treat and deal with such money, securities and property as belonging to such option customer until expiration of the term of the option or, if the option customer exercises the option, until all rights of the option customer under the commodity option have been fulfilled. Such money, securities and property (1) shall be separately accounted for and segregated as belonging to such option customer, (2) shall be kept in the United States, and (3) shall not be commingled with the money, securities or property of any other person, including the money, securities or property received by a futures commission merchant to margin, guarantee or secure the trades or contracts of commodity customers (as defined in § 1.3(k) of this chapter) or with the money accruing to such commodity customers as

the result of such trades or contracts: *Provided, however,* That the money, securities or property treated as belonging to an option customer may for convenience be commingled with the money, securities or property treated as belonging to any other option customer and deposited in the same account or accounts with any bank or trust company in the United States. Such money, securities and property, when so deposited with any bank or trust company, shall be deposited under an account name which will clearly show that it contains money, securities or property, segregated as required by this Part. Each person depositing such money, securities or property shall obtain and retain in its files for the period provided in § 1.31 of this chapter an acknowledgment from such bank or trust company that it was informed that the money, securities and property therein are being treated as belonging to option customers and are being held in accordance with the provisions of this Part. Such bank or trust company shall allow inspection of such accounts at any reasonable time by representatives of the Commission.

(b) No money, securities or property deposited in accordance with paragraph (a) of this section shall be held, disposed of, used or treated as belonging to the depositing person or any person other than the option customers of such person: *Provided, however,* That such money may be invested in obligations of the United States, and in obligations fully guaranteed as to principal and interest by the United States. Such investments shall be made through an account or accounts used for the deposit of money, securities or property received from option customers and proceeds from any sale of such obligations shall be redeposited in such account or accounts. Each person which invests money belonging to option customers in obligations as described in this paragraph (b), shall separately account for such obligations and segregate such obligations as belonging to such option customers. Such obligations may only be deposited with a bank or trust company in the United States and shall be deposited under an account name which will clearly show that it contains obligations treated as belonging to option customers, segregated as required by this Part. Each person depositing such obligations shall obtain and retain in its files an acknowledgment from such bank or trust company that it was informed that the obligations are treated as belonging to option customers and are being held in accordance with the provisions of this Part. Such acknowledgment shall be retained for the period provided in § 1.31 of this chapter. Such bank or trust company shall allow inspection of the obligations at any reasonable time by representatives of the Commission.

(c) Each person which invests money treated as belonging to option customers as permitted hereunder shall keep a record showing the following: (1) The date on which such investments were

made, (2) the name of the person through which such investments were made, (3) the amount of money so invested, (4) a description of the obligations in which such investments were made, (5) the identity of the depositories or other places where such obligations are segregated, (6) the date on which such investments were liquidated or otherwise disposed of and the amount of money received on such disposition, if any, and (7) the name of the person to or through which such investments were disposed of.

(d) Persons which invest money in obligations described in paragraph (b) of this section shall include such obligations in segregated accounts at values which at no time shall be greater than current market value, determined as of the close of the market on the last preceding market day.

(e) The deposit and/or investment of money as provided in paragraphs (a) or (b) of this section shall not operate to prevent the person so depositing and/or investing such money from receiving and retaining as its own any increment or interest resulting therefrom.

(f) The amount of money, securities and property which is and which must be in a segregated account in order to comply with the requirements of this part shall be computed by each person required to segregate such money, securities and property as of the close of each business day. A record of such computation shall be made and kept, together with all supporting data in accordance with the provisions of § 1.31 of this chapter. Such computation shall be made prior to the opening of business on the next business day.

§ 32.7 Books and record keeping.

(a) Each person which accepts any money, securities or property (or extends credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction shall keep full, complete and systematic records together with all pertinent data and memoranda of or relating to such transactions. Such records shall at least include all orders (filled, unfilled or cancelled), signature cards, books of record, journals, ledgers, cancelled checks, copies of all statements of purchase, exercise or lapse, and reports, letters, disclosure statements re-

quired by § 32.5 of this Part, solicitation or advertising material, circulars, memoranda, publications, writings, and all other literature or written advice distributed to option customers or prospective option customers. Upon the request of an authorized representative of the Commission, such person shall furnish the true name and address of each commodity option customer or prospective commodity option customer solicited.

(b) Each person referred to in paragraph (a) of this section shall also keep a record in permanent form which shall show the true name and address of each maker, underwriter, issuer or other person who assumes or purports to assume any financial responsibility for the fulfillment of any commodity option transaction solicited or accepted by such person.

(c) Each person which accepts an order for a commodity option transaction from a person other than an option customer, shall keep full, complete and systematic records together with all pertinent data and memoranda of or relating to the transaction. Such records shall at least include the items set forth in paragraph (b) of this section and, to the extent necessary to reflect such person's participation in the transaction, shall include all items set forth in paragraph (a) of this section.

(d) Each person which accepts an order for a commodity option shall immediately upon receipt thereof prepare a written record of such order, including an account identification and order number, and shall record thereon by time-stamp or other device, the date and time, to the nearest minute, that (1) the order is accepted, (2) the order is transmitted for execution, and (3) the order is executed. Each such person which accepts any money, securities, or property (or extends credit in lieu thereof) from an option customer as payment of the purchase price in connection with the commodity option transaction shall, upon confirmation that the order was executed, notify the option customer of the date that the order was executed.

(e) All records, memoranda and other documents required to be maintained by paragraphs (a) through (c), and to be prepared by paragraph (d), of this section shall be retained for the period specified in § 1.31 of this chapter, and each person required to maintain such records will be required to produce the

same for inspection and furnish true and correct copies thereof and information and reports as to the contents or meaning thereof, when and as requested by any authorized representative of the Commission or the United States Department of Justice.

§ 32.8 Unlawful representations.

It shall be unlawful for any person required to be registered with the Commission in accordance with this Part expressly or impliedly to represent that the Commission, by declaring effective the registration of such person or otherwise, has directly or indirectly approved such person, or any commodity option transaction solicited or accepted by such person.

§ 32.9 Fraud in connection with commodity option transactions.

It shall be unlawful for any person directly or indirectly—

(a) To cheat or defraud or attempt to cheat or defraud any other person;

(b) To make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof;

(c) To deceive or attempt to deceive any other person by any means whatsoever;

in or in connection with an offer to enter into, the entry into, or the confirmation of the execution of, any commodity option transaction.

§ 32.10 Option transactions entered into prior to the effective date of this part.

Nothing contained in this part shall be construed to apply to any commodity option transaction lawfully entered into prior to the effective date of this part.

Interested persons are invited to submit written comments on the proposed rules to the Commission: 2033 K Street NW., Washington, D.C. 20581, Attn: Secretariat. All submissions received prior to November 8, 1976 will be considered by the Commission in determining whether to revise or modify the proposed rules prior to their adoption or thereafter. Issued in Washington, D.C. on October 4, 1976.

By the Commission.

WILLIAM T. BAGLEY,
Chairman, Commodity Futures
Trading Commission.

[FR Doc 76-29601 Filed 10-7-76; 8:45 am]

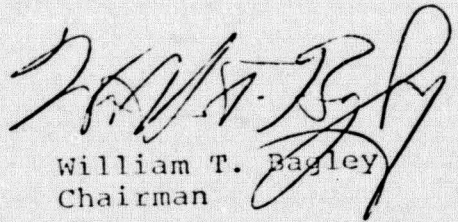
CERTIFICATE

SA 18

I, William T. Bagley, am Chairman of the Commodity Futures Trading Commission, an independent regulatory agency of the United States of America, and in such capacity I am familiar with the official records of this Commission. I hereby certify that attached hereto are true and correct copies of the following documents contained in the files of the Commission:

1. the written submissions received by the Commission in response to its proposals for regulation of commodity option transactions published in the Federal Register on April 25, 1975 (40 Fed. Reg. 18187), October 22, 1975 (40 Fed. Reg. 49360), February 20, 1976 (41 Fed. Reg. 7774) and October 8, 1976 (41 Fed. Reg. 44560); *
2. the transcript of the oral hearing held by the Commission on March 8, 1976, on regulation of commodity option transactions and the written statements submitted to the Commission in connection therewith; and
3. the Report of the Advisory Committee on Definition and Regulation of Market Instruments to the Commodity Futures Trading Commission on Recommended Policies on Commodity Options Transactions transmitted to the Commission on July 6, 1976.

Witness my hand and the official seal of the Commodity Futures Trading Commission this 3rd day of December 1976.


William T. Bagley
Chairman

RECOMMENDED POLICIES
ON
COMMODITY OPTION TRANSACTIONS

REPORT OF THE
ADVISORY COMMITTEE ON
DEFINITION AND REGULATION OF MARKET INSTRUMENTS
TO THE
COMMODITY FUTURES TRADING COMMISSION

JULY 6, 1976

JOHN V. RAINBOLT, II
CHAIRMAN

THE COMMODITY FUTURES TRADING COMMISSION
ACT OF 1974

House Hearings

The Commodity Exchange Act had granted the Commodity Exchange Authority jurisdiction over futures trading and banned privilege trading in certain agricultural commodities. Between 1936 and 1974, there was no regulation under the Act regarding those commodities which were not enumerated therein.^{37/}

In the late 1960's and early 1970's, various fraudulent schemes involving options in unregulated commodities were perpetrated on the public. The operations of Harold Goldstein of Goldstein, Samuelson, Inc., were a classic example. These operations, which defrauded customers of millions of dollars, are described in a paper included in the 1974 Senate hearings:

[Goldstein's] modus operandi, like Ponzi's, was startlingly simple, promote the organization by flamboyant advertising extolling the virtues

^{37/} The number of commodities which were regulated increased from time to time after 1936, so that at the time of the enactment of the Commodity Futures Trading Commission Act of 1974, the Act regulated "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen orange juice concentrate." Section 2(a)(1) of the Commodity Exchange Act, 7 U.S.C. §2 (1970).

of commodity options, while betting that the customer could not accurately predict price movements in the unregulated commodity markets. In the vast majority of cases, Goldstein was correct and he could keep the premiums paid by his customers. If the customer happened to get lucky, he could be paid off with funds acquired from new customers entering the market. Very little, if any, hedging with commodity futures contracts was done because it would tie up too much of the firm's capital in margin and margin call on the futures markets. The result was a naked option writing operation with 40% of the funds acquired going to pay off the occasional winner, 40% for promotional activities and a handsome 20% profit for the firm.

By late 1972 it was becoming increasingly apparent that the commodity option houses were built on a rather shaky financial foundation [T]he Securities and Exchange Commission went into federal court to have a temporary receiver appointed for the organization. In May, 1973, Harold Goldstein was indicted on sixteen counts of mail fraud. He pleaded guilty to three of those counts and was sentenced to fifteen years' imprisonment.

Goldstein, Samuelson was not alone in its tangle with state and federal agencies. Many other commodity option firms came under fire and have since gone bankrupt or ceased operations.^{38/}

These scandals led the House to propose in H.R. 11955 that the so-called world commodities as well as those previously enumerated be brought under the jurisdiction of the new commission and that option trading in all these commodities be banned.

^{38/} Hearings on S. 2485, S. 2587, S. 2837 and H.R. 13113 before the Senate Committee on Agriculture and Forestry, 93d Cong., 2d Sess., Pt. 3 at 824-825 (1974). See, also, e.g., Securities and Exchange Commission v. American Commodity Exchange, No. 75-0436-C (W.D. Okla. 1975), appeal docketed as to defendant Howard D. Williams, No. 76-1064, 10th Cir., March 26, 1976.

Witnesses who testified before the House Agriculture Committee urged that Congress not ban option trading on world commodities since various economic benefits could be derived from such trading. Several economic justifications for option trading in world commodities were put forth. It was pointed out that the United States could lose both trade and access to world commodities if the trade were banned. Options were described as useful hedging instruments to traders against price changes affecting a cash or forward position. It was also stressed that options reduced the costs of maintaining an inventory, costs which in turn would reduce the cost of the material to the consumer. Options were also cited as a means of stabilizing market prices by reducing the amplitude of the price speculations. Finally, it was stated that losses in options were limited to the amount of the premiums. 39/ Testimony was also presented to the Committee explaining the success which the London futures market had had with option trading. 39a/

The witnesses were not agreed, however, on the manner in which option trading should be regulated. One person suggested that option trading could be conducted and regulated by the exchanges without any federal control. 40/

39/ Hearings on H.R. 11955 before the House Committee on Agriculture, 93d Cong., 2d Sess. at 37, 40-41, 199, 251, 329 (1974). (hereinafter cited as "1974 House Hearings").

39a/ Id. at 176-180.

40/ Id. at 291.

Other commentators supported having all option trading conducted on and subject to the rules of a commodity exchange and cleared through a clearing house.^{41/} Others favored giving the new commission explicit authority over the commodity option market,^{42/} although one suggested that such authority be limited to domestic options, exempting London options from Commission jurisdiction.^{43/} Finally, the suggestion was made that the Commission study the problem in depth and then promulgate regulations to prevent fraud in the issuance and sale of commodity options.^{44/}

The House modified its original proposal to ban all option trading by incorporating this final approach in the bill which it adopted and sent to the Senate, H.R. 13113. That bill continued the ban on option trading for those commodities enumerated in Section 2(a)(1) of the Act. It further provided that no person could enter into a commodity option transaction in those commodities not so enumerated (the world commodities) contrary to any regulation of the

^{41/} Id. at 133, 329.

^{42/} Id. at 172, 268.

^{43/} Id. at 208.

^{44/} Id. at 196.

Commission prohibiting such transactions or allowing such transactions under terms and conditions as the Commission might prescribe. The House bill further gave the Commission the power to set different regulations for different markets. The Commission was thereby authorized to study the matter and regulate, or ban, option trading in the world commodities as it deemed appropriate.^{45/}

H.R. 13113 did not specifically outlaw "naked" options, but the House Agriculture Committee report stated:

The discretionary authority granted to the CFTC to regulate or ban trading in options and commodities not specifically named in Section 2(a)(1) of the present law (the Commodity Exchange Act, as amended) is not to be exercised by the Commission to approve any transaction of the character of, or commonly known as, an "option" . . . if the option or transaction named does not guarantee the purchase of the futures contract in fulfillment of the option, should the purchaser seek to exercise the option. The Committee intends the Commission act as expeditiously as possible to prohibit such transactions.^{46/}

Senate Hearings

Two bills were introduced in the Senate to ban all option trading.^{47/} The Senate conducted hearings on those bills, as well as on H.R. 13113. The Senate chose H.R. 13113 as

^{45/} H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 4, 17 (1974).

^{46/} Id. at 31. See also, Id. at 37.

^{47/} S. 2485, 93d Cong., 1st Sess. at 12 (Sept. 26, 1973); S. 2837, 93d Cong., 1st Sess. at 29 (Dec. 20, 1973).

the appropriate vehicle to amend the Commodity Exchange Act. The Senate made only two changes with regard to the sections which concerned options: an addition to Section 2(a)(1) to clarify that the Commission had exclusive jurisdiction over option trading and a requirement that the Commission promulgate regulations for option trading within one year.^{48/}

In addition, the Senate Committee indicated that the Commission should limit option trading as follows:

The Committee intends that options not be traded except on organized exchanges and in conformity with the rules and regulations of the Commission.^{49/}

The bill was referred to the Conference Committee in this form.

The Conference Committee

The Conference Committee approved the Senate's language clarifying the Commission's exclusive jurisdiction over options and modified the Senate's time limit for the promulgation of regulations so as to permit the Commission to take longer if it notified the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture.^{50/}

^{48/} S. Rep. No. 93-1131, 93d Cong., 2d Sess., 6, 9 (1974).

^{49/} Id. at 26.

^{50/} H.R. Rep. No. 93-1383, 93d Cong., 2d Sess., 36, 40 (1974). See also S. Rep. No. 93-1194, 93d Cong., 2d Sess. 40 (1974).

It made no other changes in the bill, and the report gives no other guidance on Congressional thoughts with respect to option trading.

The floor debates on H.R. 13113 touched only briefly on option trading. They were primarily concerned with the Commission's jurisdiction over option trading, although Senator Humphrey reiterated the Senate's belief that trading of options should occur only through designated exchanges and be cleared through clearing houses.^{51/}

With respect to commodity options, the Commodity Exchange Act, as amended by the Commodity Futures Trading Commission Act of 1974,^{52/} provides as follows:

Sec.2.(a)(1) For the purposes of this Act,
... "commodity" shall mean wheat, cotton,
rice, corn, oats, barley, rye, flaxseed, grain
sorghums, mill feeds, butter, eggs,
Solanum tuberosum (Irish potatoes), wool, wool
tops, fats and oils (including lard, tallow,
cottonseed oil, peanut oil, soybean oil and all
other fats and oils), cottonseed meal, cotton-
seed, peanuts, soybeans, soybean meal, livestock,
livestock products, and frozen concentrated
orange juice, and all other goods and articles,
except onions as provided in Public Law 85-839,
and all services, rights, and interests in which
contracts for future delivery are presently or
in the future dealt in: Provided, That the Com-
mission shall have exclusive jurisdiction with
respect to accounts, agreements (including any
transaction which is of the character of, or is
commonly known to the trade as, an "option",

^{51/} 120 Cong. Rec., S 18, 869-70 (daily ed., October 10, 1974).

^{52/} Public Law 93-463, 88 Stat. 1389 (October 23, 1974).

"privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 5 of this Act or any other board of trade, exchange, or market,

Sec. 4c.(a) It shall be unlawful for any person to offer to enter into, enter into, or confirm the execution of, any transaction involving any commodity, which is or may be used for (1) hedging any transaction in interstate commerce in such commodity or the products or by-products thereof, or (2) determining the price basis of any such transaction in interstate commerce in such commodity, or (3) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof-- . . .

(B) if such transaction involves any commodity specifically set forth in section 2(a) of this Act, prior to the enactment of the Commodity Futures Trading Commission Act of 1974, and if such transaction is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty",

(b) No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under this Act, but not specifically set forth in section 2(a) of this Act, prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms or conditions as the Commission shall prescribe within one year after the effective date of the Commodity Futures Trading Commission Act of 1974 unless the Commission determines and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that it is unable to prescribe such terms and conditions within such period of time: Provided, That any such order, rule, or

regulation may be made only after notice and opportunity for hearing: And provided further, That the Commission may set different terms and conditions for different markets. 53/

53/ 7 U.S.C. §§2, 6c (Supp. IV, 1974).

MEMORANDUM FOR: Advisory Committee on Market Instruments
FROM: Advisory Committee Staff
SUBJECT: London Commodity Options
DATE: February 9, 1976 (Amended June 3, 1976)

The following summary of trading in London commodity options was prepared by the Advisory Committee staff on the basis of conversations in London with representatives of the Bank of England (the "Bank"), the International Commodities Clearing House ("ICCH"), the London Metals Exchange ("LME"), and several trade houses which sell London options. It represents the staff's understanding of London options trading and has not been endorsed by the Commission or any of the persons with whom conversations were held. It does not purport to be a definitive study of the subject.

The history of commodity option trading in London goes back many, many years. A very active market in metals was carried on prior to World War II.

At the present time option trading in London is conducted on or through members of the LME and the coffee, cocoa, and sugar exchanges. The LME is a "principals market", without a clearinghouse, offering forward contract

trading in copper, silver, lead, tin and zinc. The coffee, cocoa, and sugar exchanges all utilize the ICCH to clear and guarantee both futures and option contracts.

Total volume of options business is quite small compared to that in futures. Depending upon the commodity involved, estimates on individual commodities ranged from less than 1% to a maximum of 15% of the total volume of trading in futures*. The overall contribution of options to volume of business done through the ICCH is about 1%. Estimates of volume of futures trades generated by one option contract ranged from 3 to 10 contracts depending on market volatility.

On both the LME and the ICCH, all commodity options call for the delivery of the underlying contract (forward contract for LME and futures for ICCH) upon exercise; all options expire or are exercised. If an individual buys an option and desires to resell that option prior to its exercise date, he in effect is long one and short one for the same exercise date. Those two positions will not offset each other and differences will not be settled until the exercise date is reached.

In the case of the LME, futures contracts and options on them represent a specific date of each month. If an individual with a position for a particular date offsets with an option contract for a different date, the adjust-

*A memorandum providing statistics on option trading as a percentage of futures trading in ICCH commodities is attached hereto.

ments are made at the first exercise date.

The Bank of England does not approve or disapprove any of the futures markets or any of the market operations or participants. These markets are essentially self-regulating. The Bank exercises general supervision over these markets within the United Kingdom and has established various "schemes" for purposes of carrying out the exchange control requirements of the United Kingdom. Participants in these commodity schemes must be nominated by their associations. The associations must have rules and regulations and means of disciplining members who may violate any of the actions of the scheme or the rules and regulations of the market.

A. The ICCH

1. Ownership of ICCH

The ICCH is a wholly-owned subsidiary of United Dominions Trust Bank (UDT), which is an "authorized" bank and, as such, acts as an agent of the Treasury for administration of the exchange control regulations. Prudential Insurance of London currently owns 20% of UDT and in that way is involved in the ownership of ICCH. The Bank's representatives indicated that they feel the Bank has a moral obligation to provide support to any authorized bank.

2. Financial Strength

It is true that UDT has had a liquidity crisis during the past year. The Life Boat Committee of the Bank was set up to operate with London clearing banks to support UDT and other banks and institutions which have had a liquidity crisis. The Life Boat Committee is currently supporting UDT. It has arranged a number of changes in operating practices at UDT, and UDT has had a change in management.

UDT feels it has a moral obligation to provide financial support to ICCH beyond its 10 million pound investment because it is "traditional" in England that a firm which owns 50% or more of any other firm has that obligation.

The ICCH feels that if the sale of London options were banned in the United States, not more than 1% of the total volume of business done by them would be affected. However, ICCH believes it would set an undesirable precedent for the United States to take such action, and from the long term conceptual standpoint, it would not be in the best interests of either the United States or London.

3. Operations of ICCH

Members of the exchanges clearing through the ICCH must also be members of the ICCH. Members of the ICCH are considered members of a "special club" because they are asked to sign general rules of membership that guide their actions and relationships with each other and the clearinghouse. They pay a 25 pound fee and annual dues of 12 pounds. The

purpose of the separate membership organization is to assure ICCH of a legal means of enforcing disciplinary action independently and uniquely against any single member. Nearly all members of the ICCH are floor members or non-trading members of exchanges, although that is not a requirement. The advantages of being a member of the ICCH include a reduction of commissions and the opportunity to deal through more than one broker offsetting open positions against each other for margin purposes, since the ICCH margins only net positions.

The sequence of events with respect to a trade are as follows:

1. The seller and buyer agree on the transaction on the floor of the particular exchange involved or during the kerb market which is conducted off the floor. Floor trades are done by open outcry. Calls, puts, and double options on futures contracts of cocoa, coffee, dry combed wool, rubber, and sugar are transacted under the regulations of the ICCH. The bids and offers made in this manner state the "premium" per ton, expressed in pounds sterling, and, when multiplied by the number of tons in the contract, represent the cost of the option. The contract price or "striking price", however, is the price at which the option can be exercised according to the contract. This price is usually the price at which the related futures contract was trading when the option was purchased. For example, a bid to buy a put of September cocoa at twenty pounds sterling when September cocoa futures in trading at four hundred pounds sterling per

ton would result in a premium of two hundred pounds sterling, (20 x 10 tons), for the contract and the "striking price" would be four hundred pounds sterling per ton.

2. The seller makes out a slip containing the information about the trade and passes that to the ICCH where it is immediately recorded.

3. At the end of the day the ICCH prepares a Daily Dealing Sheet (DDS) to notify each clearing member of the positions they have taken that day. The DDS is delivered to clearing members on the following morning.

This DDS sets forth the following information:

Description:	call, put, double
Quantity:	number of lots or contracts
Class:	whole or part, or all or none
Delivery Month	
Striking Price	
Premium	
Declaration (Expiration) Date and Time	

4. The clearing member, if in agreement with the items shown on the DDS, signs it in acceptance and returns it to the ICCH.

5. The same day he receives a Daily Registration Statement (DRS) which confirms the trade by both parties and registers it at the ICCH. In addition to the DRS the member receives a copy of the option contract. If the parties to the option have acted on behalf of a client, they do not receive the DDS but instead receive a Client's Trading Statement (CTS) which sets forth the same information as would have been shown on the DDS. The clearing members then indicate

their agreement by signing the CTS and returning it to the ICCH. The next day a DRS is received and the client is informed of the transaction by written confirmation from his broker.

6. On the morning of the third day, open interest figures are published and by the afternoon of the third day funds from individual members must be deposited in the clearinghouse. Upon receipt of the funds the clearinghouse guarantee becomes effective. (Plans are being implemented to speed up this whole process so registration and guarantee will be completed within 24 hours of the trade).

The member of the clearinghouse who is the taker, or agent for the taker, must pay the premium in cash as soon as the contract has been formally registered. This is credited by the ICCH to a "special premium account" in the name of the clearing member who is the grantor and it cannot be released to the grantor-member until the option is exercised, abandoned, or has expired. The money on deposit earns interest which is paid monthly to the seller. Other fees that are required upon registration are:

1. a registration fee, to be paid to the ICCH by each member who is a party to the option, and
2. a commission, to be paid by the client to the clearing member for the option transaction.

The ICCH requires no additional funds from the buyer for the life of the option. However, the seller must make an original margin deposit and is called upon for variation

margin daily if the market goes against him. Under the ICCH regulations, if a member fails to meet a margin call within the required time limit, the clearinghouse can treat the contract as terminated with respect to the defaulting party and may appoint a substitute grantor. In this case, the defaulting member forfeits his right to receive the premium and is charged by the clearinghouse with the difference between the "striking price" and the market price on the day of default.

If the taker abandons the option prior to or on its expiration date, notice is sent to the grantor by the ICCH, along with the premium and all margin deposits applicable to the option. This transaction is reflected on the clearinghouse sheets as of the close of business on the date of abandonment. An option upon which no action has been taken automatically expires on the declaration date, and the ICCH notifies both parties and issues clearinghouse sheets showing the expiration.

In order to exercise his option, a taker must give timely, written notice of his intention to the ICCH. This information is then forwarded to the grantor by the clearinghouse, and the cancellation of the option is effected. Simultaneously, the futures contract as specified in the option is entered in the account for each member at the "striking price" and margin is required by the ICCH to support the futures position. This is followed-up by clearinghouse sheets showing the option

cancelled and the futures position recorded. Then, all related margin deposits and premiums are released to the grantor.

A member of the ICCH who trades futures as well as options can, if he desires (it is not mandatory), open a separate account with the ICCH which is then used to identify specific cover for the options and as offsets for particular options. Variations in settlement are passed back and forth between the seller and the ICCH each day. Since the ICCH nets its futures positions and does not require segregation of option cover from other transactions in the futures market, it is possible that an individual could be carrying a large number of uncovered options.

4. Margin on Futures

Margins on futures are collected on a net basis. The contract value, the volatility of prices, and the size of the limit move allowed are all factors taken into account when the ICCH establishes margins. Margins called prior to 1:00 p.m. on any particular day must be deposited by 2:00 p.m. that day. Special deposits can be called at any time; usually a special deposit goes on automatically two months prior to the first delivery day of the futures contract.

The margin funds deposited by clearing members may include bank guarantees or cash. Bank guarantees are accepted only from: (a) "authorized" banks; (b) British clearing banks; (c) banks which are approved by the Accepting Houses

Committee; (d) major United States banks which are recognized around the world.

There is a limit on the extent that bank guarantees will be accepted from any one bank, and even a bank which meets the above criteria may have its guarantees refused, depending upon how the guarantee is drawn.

The ICCH does not require segregation of funds nor does it place any restrictions on the handling of customer and house funds. The ICCH members are audited once a year and a copy of the audit is sent to the ICCH by the auditing firm.

The ICCH does not know the mix of customer positions that an individual firm has; that is, it does not know whether the positions are backed by commercial firms or by speculators.

5. ICCH Guarantee

The ICCH guarantee extends only to its members. The ICCH will not recognize customer claims, only ICCH member claims to other members. Hence, if an ICCH member goes bankrupt, the debts settled are to other members and not to customers of the bankrupt member. The ICCH indicated it would be unwilling to extend its guarantee beyond the members of the clearing house and would have to review carefully any additional requirements imposed on its members by CFTC regulations.

Individual clearing members are not assessable in the instance of a bankruptcy of another member and are only liable for their own settlements and margins. When a clearing firm goes bankrupt, the ICCH takes their positions

into its own accounts and will either offset those or give the customers the choice of other member firms with which they would like to carry their accounts.

The ICCH has very close working relationships with control committees at each of the individual exchanges which can monitor the individual positions in the futures market and request liquidation or request reduction of positions.

B. The LME

The LME currently is composed of 28 ring members and 92 non-ring members. Call, put, or double options on LME contracts are traded but are not listed on the exchange nor guaranteed or cleared by any clearinghouse. Transactions are conducted by private arrangement between brokers and their customers. The only guarantor is the writer of the option (grantor). Upon exercise, metal options are replaced by forward contracts on the LME bearing the same specific delivery dates as the options. For example, an option to call a September 6, 1976, London silver forward contract, if exercised, is replaced by a London silver forward contract for delivery September 6, 1976, at the same "striking price" as stated in the option contract.

1. Clearing

Since metal option contracts are effected by brokers

privately, there are no supporting clearinghouse sheets. Instead, each broker confirms the important details of the contract to his client. When the broker whose client is the taker receives the premium and commission, he remits the premium to the grantor's broker who may or may not release the funds to his client. The broker for the writer of the option sends a signed copy of the contract to the taker's broker. The broker for the buyer of the option requires no other funds from his client for the life of the option, but the grantor's broker usually requires sufficient margin to cover the delivery of the corresponding forward contract, which can be quite volatile since there are no daily price limits placed on trading. Frequently, they will require as margin either the physical commodity contract, or cash in the amount of one-third of the value of the forward contract, marked to the market.

If the option is exercised, the grantor is required to issue to the taker a metal forward contract corresponding to the terms of the option. Such a contract can be acquired by bidding on the floor of the LME. When accomplished, the brokers send confirmation and copies of the signed contract to their clients. The premiums, if not previously released, and related margin deposits are then released to the original grantor.

Although there is no clearinghouse on the LME, the Bank is pushing the LME to establish a more modern system for "clearing and guaranteeing" its contracts. In talking with individual LME members, it became clear that not all ring members are equally acceptable to each other, and it is not unusual for the options sold by certain LME members to be less desirable than options from other members. Without a clearinghouse there is no neutral party for the holding of options premiums until the contract is exercised or abandoned. Hence, the seller gets paid the premium immediately upon sale of the option. He may or may not pass it on to his client if he is acting for a client.

2. Financial Guarantees for Futures Contracts

Ring members act as principals and must maintain certain financial requirements in order to continue their status as a ring member for forward dealing. Each year ring members must stand for election to the ring, and they must meet requirements of respectability and business integrity. In addition, their financial requirements include a 500,000 pound sterling bank guarantee, a 500,000 pound sterling surplus of quick assets over current liabilities, and if they are a subsidiary of another firm, a one million pound sterling guarantee by their parent company.

The LME ring members also contribute to a guarantee fund in the form of a 17,000 pound initial assessment at the time one becomes a ring member and thereafter an annual assessment based on the size of the firm. This fund is used for the mutual guarantee of all ring members, but not their customers, and is available to guarantee transactions (in forward contracts or options thereon) executed on the floor of the LME.

The Secretariat of the LME requires ring members to submit a copy of their public audit once a year. These can be conducted more frequently at the request of the Secretariat. The criteria applied by the LME in evaluating these audits seem rather vague and perhaps are selectively applied.

3. Origination and Resale of Options

Although exact data is not available, the impression was given that most options granted on LME contracts originate through not more than two or three firms and that most of the option customers of those firms are engaged in the metals business and may be writing options on their physical inventories.

LME members who grant options sometimes have other firms associated with them who act as a sales organization for LME options. These associated firms operate under the name of the grantor or guarantor of the option in some instances; in others, they do not. There is very little control exercised over how and to whom the options are subsequently sold.

C. Selling London Options in the United States

The sequence of events for the sale of London options in the United States varies, but generally it proceeds as follows: A firm calls a ring member of the LME and indicates that it would like to sell an option on May 9th copper. The option is offered to another ring member, who accepts the offer, either for itself or on the basis of an order received for a customer in the United States. It may resell the option through an affiliated or unaffiliated retail firm in the United States or directly to a United States customer.

When it resells the option, it will usually rewrite the contract, indicating the option is now granted by them instead of by the original grantor. That option may be retailed in the United States as an option granted by the United States representative, or it may be retailed as an option carrying the London seller's name. Most traders indicated that they looked to the United States account as simply an omnibus account and were not concerned about separation of the United States vendor's customers' transactions from his house trades. They collected their premiums up-front from United States customers by having deposits made either in United States banks or wired directly to London. It was only upon receipt of the funds in London or assurance from the United States bank through the London office that the funds had been received in the United States that an option was actually granted to the United States account.

Option sellers in London do not know who subsequent United States customers are and in the instance of a bankruptcy would not recognize them as having any valid claim, except through the person who sold the option in the United States. Such a claim would have to show that the option entered into in London was indeed the same option sold to the person in the United States.

Each person in the distribution chain tends to act as a principal or at least think of himself as a principal, rather than as an agent for others. There is some confusion over this. In visits with lawyers in England who have experience in this area, it was indicated that it depends very much on how the particular option contract furnished to the customer is written. If the contract indicates specifically that it was entered into "for the account of" the customer, it would be considered an agency agreement. If it is entered into "to the account of" the customer, they consider it a principal agreement.

It was given as a legal interpretation that any person in the chain who acts as an agent for an undisclosed or unidentified principal acts, and is treated, as if he was a principal to the contract. It was also indicated that an important test case between a major United States brokerage house and some Dutch customers is pending before an arbitration committee of the Cocoa Terminal Market Association.

Some of the schemes for selling options in the United States include the following: A contract for options on London futures is issued with the premiums and fees indicated on the contract. The individual retailing that option in the United States purchases that contract for his account. He receives a copy of the contract and crosses out the information about the premiums and commissions and puts in a "foreign management fee". He then photostats the contract and each client gets a copy of the contract indicating that he has a certain percentage interest in that contract. The danger in this is that an individual omnibus account could sell more than 100% of the contract.

Another way of doing it is to obtain ICCH form contracts which are printed and sold by the ICCH to brokers. These are subsequently resold to people in the United States as if they carried the ICCH guarantee, when in fact they are just pieces of paper.

Commingling of monies and trading against customer orders

A major problem arises in the instance that a firm in the United States retailing London options in the United States trades against its customers positions. The problem stems from the "omnibus account" treatment by the London seller of all orders received from a United States retailer of options. A distinction is made between orders received which represent orders received from customers of the United States firm and orders for the United States firm's own benefit. Since the settlements in the account are netted out

on the London side, large losses on the house positions may jeopardize the ability of the United States firm to satisfy the claims of its customers who have profitable trades. This becomes a particularly severe problem when the United States firms are undercapitalized.

Some London firms are more strict than others in their dealings with United States institutions who retail their options. Some firms indicated they would not allow the use of their name in a subsequent sale of the options to other customers. They would not finance a United States retail operation, and they required the receipt of premiums and any other fees in their bank account in the United States or in London prior to the establishment of any option position for the account of the United States firm.

There was an indication that there has been recent growth in commodity syndicates, commodity funds, and pooled accounts in London and that a number of these funds are being sold in the United States. These funds and pooled accounts are generally set up outside of the United Kingdom which prevents the advertising of such funds, although they can be sold privately.

D. Summary and Conclusions

1. The London business in commodity options is quite small in terms of total volume of futures business, but is highly concentrated among a few firms.

2. Operationally, there is probably a justification for a higher degree of confidence as to the financial guarantee that backs the ICCH than there is for the LME. This stems largely from the fact that the ICCH is more institutionalized and seems to have a better degree of control over the market exposure of its members. In addition, the Bank exercises some degree of oversight over ICCH operations.

3. There is probably no difference between the LME and ICCH in the degree of protection afforded United States customers. (a) The guarantees of ICCH and LME extend only to their respective clearing members and not to any of their customers; (b) There seems to be a principal-to-principal relationship between parties all the way through the chain of transactions from the originating/granting party in London to the purchaser of an option in the United States; (c) Those London firms that are selling options to United States firms or who retail them in the United States exercise very little control over how the options are sold in the United States and to whom they are sold; (d) United States firms retailing London options in the United States carry single accounts with their London counterparts. This means customer and house accounts are commingled; (e) It is very difficult to identify whether the options sold in the United States are authentically conveyed in London.

Section 4c(b) of the Commodity Exchange Act, 7 U.S.C. § 6c(b) (Supp. V, 1975)

§ 6c. Wash sales; cross trades; fictitious sales; privileges; offers; puts; calls; guaranties.

(b) No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under this chapter, but not specifically set forth in section 2 of this title, prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe within one year after the effective date of the Commodity Futures Trading Commission Act of 1974 unless the Commission determines and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that it is unable to prescribe such terms and conditions within such period of time: *Provided*, That any such order, rule, or regulation may be made only after notice and opportunity for hearing: *And provided further*, That the Commission may set different terms and conditions for different markets. (As amended Oct. 23, 1974, Pub. L. 93-463, title I, § 103(a), title IV, § 402, 88 Stat. 1392, 1412.)

Section 8a(5) of the Commodity Exchange Act, 7 U.S.C. § 12a(5) (Supp. V, 1975)

§ 12a. Registration of commission merchants and brokers; fees; rules and regulations; publication of harmful acts; disapproval of by laws, etc.

The Commission is authorized—

(5) to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of this chapter;

Section 15 of the Commodity Exchange Act, 7 U.S.C. § 19 (Supp. V, 1975)

§ 19. Antitrust laws; anticompetitive means.

The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this chapter, as well as the policies and purposes of this chapter, in issuing any order or adopting any Commission rule or regulation, or in requiring or approving any bylaw, rule, or regulation of a contract market or registered futures association established pursuant to section 21 of this title. (Sept. 21, 1922, ch. 369, § 15, as added Oct. 23, 1974, Pub. L. 93-463, title I, § 107, 88 Stat. 1395.)

Section 4 of the Administrative Procedure Act, 5 U.S.C. § 553 (1970)

§ 553. Rule making

(a) This section applies, according to the provisions thereof, except to the extent that there is involved—

(1) a military or foreign affairs function of the United States; or

(2) a matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts.

(b) General notice of proposed rule making shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include—

(1) a statement of the time, place, and nature of public rule making proceedings;

(2) reference to the legal authority under which the rule is proposed; and

(3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.

Except when notice or hearing is required by statute, this subsection does not apply—

(A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or

(B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

(c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. When rules are required by statute to be made on the record after opportunity for an agency hearing, sections 556 and 557 of this title apply instead of this subsection.

(d) The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except—

(1) a substantive rule which grants or recognizes an exemption or relieves a restriction;

(2) interpretative rules and statements of policy; or

(3) as otherwise provided by the agency for good cause found and published with the rule.

(e) Each agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule. Pub.L. 89-554, Sept. 6, 1966, 80 Stat. 383.

Section 10(e) of the Administrative Procedure Act, 5 U.S.C. § 706 (1970)

§ 706. Scope of review

To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall—

(1) compel agency action unlawfully withheld or unreasonably delayed; and

(2) hold unlawful and set aside agency action, findings, and conclusions found to be—

(A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;

(B) contrary to constitutional right, power, privilege, or immunity;

(C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;

(D) without observance of procedure required by law;

(E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or

(F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.

In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error. Pub.L. 89-554, Sept. 6, 1966, 80 Stat. 393.

Regulation 1.17, 17 C.F.R. § 1.17
(1976)

§ 1.17 Minimum financial requirements. /SA 51

(a) Except as provided in paragraph (b) of this section, no person applying for registration as futures commission merchant shall be so registered unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (1) \$10,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(b) The requirements of paragraph (a) of this section shall not be applicable if the applicant for registration or registrant is a member of a contract market and conforms to minimum financial standards and related reporting requirements set by such contract market in its bylaws, rules, regulations or resolutions approved by the Commission.

(c) Definitions: For the purposes of this section:

(1) The term "working capital" means the amount by which current assets exceed current liabilities.

(2) The term "current assets" means cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold during the next twelve months in the normal course of operation of the principal business of the applicant or registrant, and which are available for the intended for payment of current liabilities. The term "current assets" excludes:

(i) Any unsecured customer's commodity futures account containing a ledger balance and open trades, the combination of which liquidates to a deficit or containing a debit ledger balance only and which account has been in such condition for more than 30 consecutive days;

(ii) [Reserved]

(iii) Any unsecured commodity futures account, which is a "proprietary account" as defined in § 1.3(y) and which account contains a ledger balance and open trades, the combination of which liquidates to a deficit or contains a debit ledger balance only;

(iv) [Reserved]

(v) Any unsecured loan or advance on the part of applicant or registrant to any person whose account is classifiable as a proprietary account under these regulations;

(vi) Crop loan (loans made to farmers for the purpose of financing their crops or farm operations) which are not (a) due and collectable within nine months after the respective dates of the making of such loans, and (b) evidenced by legally enforceable written instruments in the possession of the applicant or registrant;

(vii) All other unsecured receivables that are not due within six months from the respective dates of their inception;

(viii) All unsecured receivables that are not collectable within six months from the respective dates of their inception;

(ix) All past due unsecured receivables:

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Title 17—Commodity and Securities Exchanges

(x) Exchange memberships, clearing house stocks and guaranty funds;

(xi) Unrealized commissions on open futures contracts;

(xii) Cash and claims to cash which are restricted as to withdrawal;

(xiii) Fixed assets, such as land, building, furniture and fixtures, improvements to real property;

(xiv) Prepaid expenses and deferred charges;

(xv) Securities without a ready market; and

(xvi) Everything excluded from such term in accord with generally accepted accounting principles.

(3) A loan or advance or any other form of receivable shall not be considered secured unless the following conditions exist:

(i) The receivable is secured by collateral which can be readily converted into cash equal to or in excess of that part of the receivable which is shown in the creditor's records as secured; and

(ii) The collateral is in the possession and control of the creditor; or

(iii) The creditor has a legally enforceable, written security agreement, signed by the debtor, and has a perfected security interest in the collateral within the meaning of the laws of the state in which the collateral is located.

(4) The term "current liabilities" means obligations that are due and payable or will become due and payable in the next 12 months, or the liquidation of which is reasonably expected to require the use of existing resources classifiable as current assets or the creation of other current liabilities. It would include any long-term loan which is not evidenced by a legally enforceable written instrument and any long-term liability that can be accelerated at the creditor's option to a term of a year or less. For the purpose of computing "working capital" within the meaning of this section, the following amounts may be excluded from current liabilities:

(i) The amount of indebtedness subordinated to the claims of all general creditors of the applicant or registrant pursuant to a satisfactory subordination agreement, as hereinafter defined; and

(ii) The amount of money, securities and property due to commodity customers, which is held in segregated accounts in compliance with the requirements of section 4d(2) of the Act and the regulations thereunder: *Provided, however*, That such exclusion may be

taken only if such money, securities and property held in segregated accounts has also been excluded from current assets in computing working capital.

(5) The term "satisfactory subordination agreement" means an agreement which satisfies all the following conditions:

(i) It is a written agreement duly executed by the applicant or registrant and the lender or creditor, which agreement is legally binding and enforceable in accordance with its terms upon the lender or creditor and his creditors, heirs, executors, administrators, assigns and successors in interest;

(ii) It effectively subordinates any right of the lender or creditor to demand or receive payment or return of the cash, securities or property loaned or otherwise owed, to the claims of all present and future creditors of the registrant or applicant: *Provided, however*, With the consent of the borrower, prior to the maturity of the agreement, the lender may substitute cash or other assets, with a ready market at an equal or greater value, for the assets initially loaned, if the agreement provides for such substitution and is modified so that the substitute cash or assets are subordinated in accordance with this regulation;

(iii) The agreement shall be in effect for a period of not less than one year.

(iv) It provides that the agreement shall not be subject to cancellation by either party, and that the loan shall not be repaid and the agreement shall not be terminated, rescinded or modified by mutual consent or otherwise if the effect thereof would be to make the agreement inconsistent with the conditions of this regulation or to reduce the adjusted working capital of the applicant or registrant below the amount required by this regulation;

(v) Sole possession and control of the subordinated assets must be maintained by the borrower for the term of the agreement;

(vi) It provides that no default in the payment of interest or in the performance of any covenant or condition by the registrant or applicant shall have the effect of accelerating the maturity of the indebtedness;

(vii) It provides that any notes or other written instruments evidencing the indebtedness shall bear on their face an appropriate legend stating that such notes or instruments are issued subject to the provisions of a subordination

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agreement which shall be adequately referred to and incorporated by reference;

(viii) It provides that any securities or other property loaned to the registrant or applicant pursuant to its provisions may be used and dealt with by the registrant or applicant as part of his capital and shall be subject to the risks of the business; and

(ix) Copies of each such agreement and of any notes or written instruments, evidencing the indebtedness are filed, within 10 days after each such agreement is entered into, with the regional office of the Commission for the region in which the registrant or applicant maintains his principal place of business, together with a statement of the full name and address of the lender or creditor and the business relationship of the lender or creditor to the registrant or applicant.

(6) The term "adjusted working capital" means working capital less:

(i) Five percent of all unsecured receivables used by the applicant or registrant in computing his working capital;

(ii) The amount by which any advances paid by the applicant or registrant on cash commodity contracts and used in computing his working capital, exceeds 90 percent of the market value of the commodities covered by such contracts;

(iii) In the case of cash commodity inventories that are hedged by bona fide hedging positions in the futures markets (as defined in § 1.3(z) of these regulations), the amount by which the value of such inventories used by the applicant or registrant in computing his working capital, exceeds 95 percent of the market value of such inventories;

(iv) In the case of all inventories which are included as current assets and which are not hedged in futures markets, the amount by which the value of such inventories used by the applicant or registrant in computing his working capital exceeds 80 percent of the market value of such inventories; *Provided, however*, That with respect to those units of inventory that are committed to fixed price sales, there shall be no deduction from the value of such units of inventory used by the applicant or registrant in computing his working capital if the value so used does not exceed the committed sales price;

(v) The amount by which the value of securities and obligations used by the ap-

plicant or registrant in computing his working capital exceeds:

(A) In the case of preferred stocks, 80 percent of the market value thereof;

(B) In the case of common stocks, 70 percent of the market value thereof;

(C) In the case of commercial bonds and revenue bonds, 90 percent of the market value thereof;

(D) In the case of obligations of, or guaranteed by, the United States, and of general obligations of any State, or of any political subdivision thereof, 100 percent of the market value thereof;

(E) In the case of all other securities classifiable as current assets under this regulation, 70 percent of the market value thereof; and

(vi) That amount of subordinated borrowings and other forms of subordinated indebtedness which is in excess of 75 percent of the total of capital and subordinated liabilities.

(7) The term "aggregate indebtedness" means that portion of the total liabilities of an applicant or registrant which is not adequately collateralized, but excluding:

(i) Advances received by the applicant or registrant against bills of lading issued in connection with the shipment of commodities sold by the applicant or registrant;

(ii) Equities in partners' and officers' commodity futures accounts;

(iii) Equities in customers' commodity futures accounts segregated in accordance with the Act and regulations; and

(iv) The amount of indebtedness subordinated to the claims of all general creditors of the applicant or registrant pursuant to a satisfactory subordination agreement, as defined in this section.

(8) Liabilities shall be deemed to be "adequately collateralized" when, pursuant to a legally-enforceable written instrument, such liabilities are secured by identified assets that are otherwise unencumbered and the market value of which exceeds the amount of such liabilities by 10 percent or more.

(d) In the case of open futures contracts held in customers' accounts carried by the applicant or registrant, the safety factor shall be one-half of one percent of the market value of the greater of either the total long or total short futures contracts in each commodity in all such accounts: *Provided, however*, (1) That such safety factor shall not apply to any spread or straddle held for the same account in the same

commodity, on the same market, in the same crop year, and (2) that in the case of any intermarket or intercrop year spread or straddle, or any intermarket and intercrop year spread, held for the same account in the same commodity, the safety factor shall be one-fourth of one percent of the market value of that side of each such spread or straddle having the greater market value.

(e) In the case of open futures contracts held in proprietary accounts carried by the applicant or registrant, the safety factor shall be 10 percent of the market value of the greater of either the total long or total short futures contracts in each commodity in all such accounts: *Provided, however*, (1) That such safety factor shall not apply to any spread or straddle held for the same account in the same commodity, on the same market, in the same crop year, or to any contract representing a bona fide hedging transaction as defined in § 1.3 (z) (however, such factor shall apply to contracts specified in paragraph (4) of § 1.3(z), representing hedges against unfilled anticipated requirements); nor shall it apply to any contract resulting from a "changer trade" made in accordance with the rules of a contract market which have been submitted to and approved by the Commission, and (2) that in the case of any intermarket or intercrop year spread or straddle, or any intermarket and intercrop year spread or straddle, held for the same account in the same commodity, the safety factor shall be 5 percent of the market value of that side of each such spread or straddle having the greater market value.

Regulation 1.19. 17 C.F.R. § 1.19 (1976)

PROHIBITED TRADING IN COMMODITY OPTIONS

§ 1.19 Prohibited trading in "puts" and "calls" in commodities.

No futures commission merchant shall make, underwrite, issue, or otherwise assume any financial responsibility for the fulfillment of, any transaction which is of the character of, or is commonly known to the trade as, an "option," "privilege," "indemnity," "bid," "offer," "put," "call," "advance guaranty," or "decline guaranty" in any commodity.

(Secs. 4c(a), 4f, 5, 49 Stat. 1494, 1495, 82 Stat. 28, 88 Stat. 1392, 1412; 7 U.S.C. 6c(a), 6f, 7)



COMMODITY FUTURES TRADING COMMISSION

2033 K Street, N.W., Washington, D.C. 20581

OFFICE OF
THE GENERAL COUNSEL

February 3, 1977

A. Daniel Fusaro, Esquire
Clerk, United States Court of Appeals
for the Second Circuit
United States Courthouse
Foley Square
New York, New York 10007

Re: British American Commodity Options Corp. v.
Bagley, Nos. 77-6010, -6011, -6019 (C.A. 2)

Dear Mr. Fusaro:

Enclosed for filing with the Court in the above-referenced case in accordance with the Court's Orders of January 18, 1977, are an original and three typewritten copies of the BRIEF OF THE COMMODITY FUTURES TRADING COMMISSION AND ITS MEMBERS, APPELLEES-CROSS APPELLANTS.

I hereby certify that on February 3, 1977, I have caused to be served, by United States mail, first class, postage prepaid true copies of the Commission's brief upon counsel for appellants-cross appellees as follows:

Charles J. Hecht, Esq.
60 East 42d Street
New York, New York 10017

Leonard Goldstein, Esq.
Suite 700
1666 K Street, N.W.
Washington, D. C. 20006

Martin Kaplan, Esq.
Gusrae, Greene & Kaplan
67 Wall Street
New York, New York

It is the intention of Commission counsel also to effect personal delivery of the Commission's brief upon appellants' counsel today.

Sincerely,

Virginia F. Crisman
Virginia Crisman
Attorney

Enclosures